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decreases in our revenue and operating margin. Any such changes or adjustments may cause our quarter-to-quarter results of operations to fluctuate.

In addition, the timing of customer additions is not uniform throughout the year, which causes fluctuations in our quarterly results as new customers are added. Operating margins are typically slightly lower in quarters in which we add new customers because we incur expenses to implement our operating model at those customers while our incentive payments from revenue improvements and operating cost reductions for those customers are only at a preliminary stage. We also experience fluctuations in incentive payments as a result of patients' ability to accelerate or defer elective procedures, particularly around holidays such as Thanksgiving and Christmas. Generally, incentive payments are lower in the first quarter of each year and higher in the fourth quarter of each year. Incentive payments have a significant impact on operating margins and adjusted EBITDA, and changes in the amount of incentive payments can cause fluctuations in our quarter-to-quarter operating results.

*If we lose key personnel or if we are unable to attract, hire, integrate and retain key personnel and other necessary employees, our business would be harmed.*

Our future success depends in part on our ability to attract, hire, integrate and retain key personnel. Our future success also depends on the continued contributions of our executive officers and other key personnel, each of whom may be difficult to replace. In particular, Mary A. Tolan, our president and chief executive officer, is critical to the management of our business and operations and the development of our strategic direction. The loss of services of Ms. Tolan or any of our other executive officers or key personnel or the inability to continue to attract qualified personnel could have a material adverse effect on our business. The replacement of any of these key personnel would involve significant time and expense and may significantly delay or prevent the achievement of our business objectives. Competition for the caliber and number of employees we require is intense. We may face difficulty identifying and hiring qualified personnel at compensation levels consistent with our existing compensation and salary structure. In addition, we invest significant time and expense in training each of our employees, which increases their value to competitors who may seek to recruit them. If we fail to retain our employees, we could incur significant expenses in hiring, integrating and training their replacements and the quality of our services and our ability to serve our customers could diminish, resulting in a material adverse effect on our business.

*The imposition of legal responsibility for obligations related to our employees or our customers' employees could adversely affect our business or subject us to liability.*

Under our contracts with customers, we directly manage our customers' employees engaged in the activities we have contracted to manage for our customers. Our managed service contracts establish the division of responsibilities between us and our customers for various personnel management matters, including compliance with and liability under various employment laws and regulations. We could, nevertheless, be found to have liability with our customers for actions against or by employees of our customers, including under various employment laws and regulations, such as those relating to discrimination, retaliation, wage and hour matters, occupational safety and health, family and medical leave, notice of facility closings and layoffs and labor relations, as well as similar liability with respect to our own employees, and any such liability could result in a material adverse effect on our business.

*If we fail to manage future growth effectively, our business would be harmed.*

We have expanded our operations significantly since inception and anticipate expanding further. For example, our net services revenue increased from \$160.7 million in 2006 to \$606.3 million in 2010, and the number of our employees increased from 33, all of whom were full-time, as of January 1, 2005 to 1,991 full-time employees and 231 part-time employees as of December 31, 2010. In addition, the number of customer employees whom we manage has increased from approximately 1,600 as of January 1, 2005 to approximately 8,200 as of December 31, 2010. This growth has placed significant demands on our management, infrastructure and other resources. To manage future growth, we will need to hire, integrate and retain highly skilled and motivated employees, and will need to effectively manage a growing number of customer employees

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engaged in revenue cycle operations. We will also need to continue to improve our financial and management controls, reporting systems and procedures. If we do not effectively manage our growth, we may not be able to execute on our business plan, respond to competitive pressures, take advantage of market opportunities, satisfy customer requirements or maintain high-quality service offerings.

### *Disruptions in service or damage to our data centers and shared services centers could adversely affect our business.*

Our data centers and shared services centers are essential to our business. Our operations depend on our ability to operate our shared service centers, and to maintain and protect our applications, which are located in data centers that are operated for us by third parties. We cannot control or assure the continued or uninterrupted availability of these third-party data centers. In addition, our information technologies and systems, as well as our data centers and shared services centers, are vulnerable to damage or interruption from various causes, including (i) acts of God and other natural disasters, war and acts of terrorism and (ii) power losses, computer systems failures, Internet and telecommunications or data network failures, operator error, losses of and corruption of data and similar events. We conduct business continuity planning and maintain insurance against fires, floods, other natural disasters and general business interruptions to mitigate the adverse effects of a disruption, relocation or change in operating environment at one of our data centers or shared services centers, but the situations we plan for and the amount of insurance coverage we maintain may not be adequate in any particular case. In addition, the occurrence of any of these events could result in interruptions, delays or cessations in service to our customers, or in interruptions, delays or cessations in the direct connections we establish between our customers and third-party payors. Any of these events could impair or prohibit our ability to provide our services, reduce the attractiveness of our services to current or potential customers and adversely impact our financial condition and results of operations.

In addition, despite the implementation of security measures, our infrastructure, data centers, shared services centers or systems that we interface with, including the Internet and related systems, may be vulnerable to physical break-ins, hackers, improper employee or contractor access, computer viruses, programming errors, denial-of-service attacks or other attacks by third parties seeking to disrupt operations or misappropriate information or similar physical or electronic breaches of security. Any of these can cause system failure, including network, software or hardware failure, which can result in service disruptions. As a result, we may be required to expend significant capital and other resources to protect against security breaches and hackers or to alleviate problems caused by such breaches.

### *If our security measures are breached or fail and unauthorized access is obtained to a customer's data, our service may be perceived as not being secure, the attractiveness of our services to current or potential customers may be reduced, and we may incur significant liabilities.*

Our services involve the storage and transmission of customers' proprietary information and protected health, financial, payment and other personal information of patients. We rely on proprietary and commercially available systems, software, tools and monitoring, as well as other processes, to provide security for processing, transmission and storage of such information, and because of the sensitivity of this information, the effectiveness of such security efforts is very important. The systems currently used for transmission and approval of credit card transactions, and the technology utilized in credit cards themselves, all of which can put credit card data at risk, are determined and controlled by the payment card industry, not by us. If our security measures are breached or fail as a result of third-party action, employee error, malfeasance or otherwise, someone may be able to obtain unauthorized access to customer or patient data. Improper activities by third parties, advances in computer and software capabilities and encryption technology, new tools and discoveries and other events or developments may facilitate or result in a compromise or breach of our computer systems. Techniques used to obtain unauthorized access or to sabotage systems change frequently and generally are not recognized until launched against a target, and we may be unable to anticipate these techniques or to implement adequate preventive measures. Our security measures may not be effective in preventing these types of activities, and the security measures of our third-party data centers and service providers may not be adequate. If a breach of our security occurs, we could face damages for contract breach,

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penalties for violation of applicable laws or regulations, possible lawsuits by individuals affected by the breach and significant remediation costs and efforts to prevent future occurrences. In addition, whether there is an actual or a perceived breach of our security, the market perception of the effectiveness of our security measures could be harmed and we could lose current or potential customers.

*We may be liable to our customers or third parties if we make errors in providing our services, and our anticipated net services revenue may be lower if we provide poor service.*

The services we offer are complex, and we make errors from time to time. Errors can result from the interface of our proprietary technology applications and a customer's existing patient accounting system, or we may make human errors in any aspect of our service offerings. The costs incurred in correcting any material errors may be substantial and could adversely affect our operating results. Our customers, or third parties such as our customers' patients, may assert claims against us alleging that they suffered damages due to our errors, and such claims could subject us to significant legal defense costs and adverse publicity regardless of the merits or eventual outcome of such claims. In addition, if we provide poor service to a customer and the customer therefore realizes less improvement in revenue yield, the incentive fee payments to us from that customer will be lower than anticipated.

*We offer our services in many jurisdictions and, therefore, may be subject to state and local taxes that could harm our business or that we may have inadvertently failed to pay.*

We may lose sales or incur significant costs should various tax jurisdictions be successful in imposing taxes on a broader range of services. Imposition of such taxes on our services could result in substantial unplanned costs, would effectively increase the cost of such services to our customers and may adversely affect our ability to retain existing customers or to gain new customers in the areas in which such taxes are imposed. For example, in 2008 Michigan began to impose a tax based on gross receipts in addition to tax based on net income.

*We may seek to expand into international markets in the future. We have no experience in providing services to customers outside of the United States. Expansion into international markets, if pursued, could expose us to additional risks that we do not face in the United States, which could have an adverse effect on our operating results.*

To date, all customers for all of our service offerings have been located in the United States. We believe that increasing healthcare costs are a concern for other developed nations and that management of the health of a defined patient population is a cost effective means to control overall healthcare expenditures. We have received inquiries from government-related healthcare providers in other countries about our quality and total cost of care service offering. As a result, we are beginning to evaluate the level of potential interest in this service offering and the methods of delivering this solution to international customers. This process is in a very early stage and there is no assurance that our quality and total cost of care service offering can be successfully tailored to meet the specific requirements of healthcare providers outside the United States, that a market for this service will develop outside of the United States or that we will be able to serve this market efficiently.

We have no experience in providing services to customers outside of the United States. If we seek to expand into international markets in the future, such operations will be subject to a variety of legal, financial, operational, regulatory, economic and political risks that we do not face in the United States. We may not be successful in developing and implementing policies and strategies that would be effective in managing these risks in each country where we may seek to do business. Our failure to manage these risks successfully could harm our operations and increase our costs, and put pressure on our business, financial condition and operating results.

*Our growing operations in India expose us to risks that could have an adverse effect on our costs of operations.*

We employ a significant number of persons in India and expect to continue to add personnel in India. While there are cost advantages to operating in India, significant growth in the technology sector in India has

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increased competition to attract and retain skilled employees and has led to a commensurate increase in compensation expense. In the future, we may not be able to hire and retain such personnel at compensation levels consistent with our existing compensation and salary structure in India. In addition, our reliance on a workforce in India exposes us to disruptions in the business, political and economic environment in that region. Maintenance of a stable political environment is important to our operations, and terrorist attacks and acts of violence or war may directly affect our physical facilities and workforce or contribute to general instability. Our operations in India require us to comply with local laws and regulatory requirements, which are complex and of which we may not always be aware, and expose us to foreign currency exchange rate risk. Our Indian operations may also subject us to trade restrictions, reduced or inadequate protection for intellectual property rights, security breaches and other factors that may adversely affect our business. Negative developments in any of these areas could increase our costs of operations or otherwise harm our business.

### ***Negative public perception in the United States regarding offshore outsourcing and proposed legislation may increase the cost of delivering our services.***

Offshore outsourcing is a politically sensitive topic in the United States. For example, various organizations and public figures in the United States have expressed concern about a perceived association between offshore outsourcing providers and the loss of jobs in the United States. In addition, there has been recent publicity about the negative experience of certain companies that use offshore outsourcing, particularly in India. Current or prospective customers may elect to perform such services themselves or may be discouraged from transferring these services from onshore to offshore providers to avoid negative perceptions that may be associated with using an offshore provider. Any slowdown or reversal of existing industry trends towards offshore outsourcing would increase the cost of delivering our services if we had to relocate aspects of our services from India to the United States where operating costs are higher.

Legislation in the United States may be enacted that is intended to discourage or restrict offshore outsourcing. In the United States, federal and state legislation has been proposed, and enacted in several states, that could restrict or discourage U.S. companies from outsourcing their services to companies outside the United States. For example, legislation has been proposed that would require offshore providers to identify where they are located. In addition, legislation has been enacted in at least one state that requires that state contracts for services be performed within the United States, while several other states provide a preference to state contracts that are performed within the state. It is possible that legislation could be adopted that would restrict U.S. private sector companies that have federal or state government contracts, or that receive government funding or reimbursement, such as Medicare or Medicaid payments, from outsourcing their services to offshore service providers. Any changes to existing laws or the enactment of new legislation restricting offshore outsourcing in the United States may adversely affect our ability to do business, particularly if these changes are widespread, and could have a material adverse effect on our business, results of operations, financial condition and cash flows.

## **Regulatory Risks**

### ***The healthcare industry is heavily regulated. Our failure to comply with regulatory requirements could create liability for us, result in adverse publicity and negatively affect our business.***

The healthcare industry is heavily regulated and is subject to changing political, legislative, regulatory and other influences. Many healthcare laws are complex, and their application to specific services and relationships may not be clear. In particular, many existing healthcare laws and regulations, when enacted, did not anticipate the services that we provide. There can be no assurance that our operations will not be challenged or adversely affected by enforcement initiatives. Our failure to accurately anticipate the application of these laws and regulations to our business, or any other failure to comply with regulatory requirements, could create liability for us, result in adverse publicity and negatively affect our business. Federal and state legislatures and agencies periodically consider proposals to revise aspects of the healthcare industry or to revise or create additional statutory and regulatory requirements. Such proposals, if implemented, could impact our operations, the use of our services and our ability to market new services, or could create unexpected liabilities for us. We are unable to predict what changes to laws or regulations might be made in the future or how those changes could affect our business or our operating costs.

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### ***Developments in the healthcare industry, including national healthcare reform, could adversely affect our business.***

The healthcare industry has changed significantly in recent years and we expect that significant changes will continue to occur. The timing and impact of developments in the healthcare industry are difficult to predict. We cannot be sure that the markets for our services will continue to exist at current levels or that we will have adequate technical, financial and marketing resources to react to changes in those markets. The federal healthcare reform legislation (known as the Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act of 2010) that was enacted in March 2010 could, for example, encourage more companies to enter our market, provide advantages to our competitors and result in the development of solutions that compete with ours. Moreover, healthcare reform remains a major policy issue at the federal level, and constitutional challenges to or the repeal of the existing legislation and additional healthcare legislation in the future could have adverse consequences for us or the customers we serve.

### ***If a breach of our measures protecting personal data covered by the Health Insurance Portability and Accountability Act or Health Information Technology for Economic and Clinical Health Act occurs, we may incur significant liabilities.***

The Health Insurance Portability and Accountability Act of 1996, as amended, and the regulations that have been issued under it, which we refer to collectively as HIPAA, contain substantial restrictions and requirements with respect to the use and disclosure of individuals' protected health information. Under HIPAA, covered entities must establish administrative, physical and technical safeguards to protect the confidentiality, integrity and availability of electronic protected health information maintained or transmitted by them or by others on their behalf. In February 2009 HIPAA was amended by the Health Information Technology for Economic and Clinical Health, or HITECH, Act to impose certain of the HIPAA privacy and security requirements directly upon business associates of covered entities. New regulations that took effect in late 2009 also require business associates to notify covered entities, who in turn must notify affected individuals and government authorities of data security breaches involving unsecured protected health information. Most of our customers are covered entities and we are a business associate to many of those customers under HIPAA and the HITECH Act as a result of our contractual obligations to perform certain functions on behalf of and provide certain services to those customers. We have implemented and maintain physical, technical and administrative safeguards intended to protect all personal data and have processes in place to assist us in complying with applicable laws and regulations regarding the protection of this data and properly responding to any security incidents. A knowing breach of the HITECH Act's requirements could expose us to criminal liability. A breach of our safeguards and processes that is not due to reasonable cause or involves willful neglect could expose us to civil penalties and the possibility of civil litigation.

### ***If we fail to comply with federal and state laws governing submission of false or fraudulent claims to government healthcare programs and financial relationships among healthcare providers, we may be subject to civil and criminal penalties or loss of eligibility to participate in government healthcare programs.***

A number of federal and state laws, including anti-kickback restrictions and laws prohibiting the submission of false or fraudulent claims, apply to healthcare providers, physicians and others that make, offer, seek or receive referrals or payments for products or services that may be paid for through any federal or state healthcare program and, in some instances, any private program. These laws are complex and their application to our specific services and relationships may not be clear and may be applied to our business in ways that we do not anticipate. Federal and state regulatory and law enforcement authorities have recently increased enforcement activities with respect to Medicare and Medicaid fraud and abuse regulations and other healthcare reimbursement laws and rules. From time to time, participants in the healthcare industry receive inquiries or subpoenas to produce documents in connection with government investigations. We could be required to expend significant time and resources to comply with these requests, and the attention of our management team could be diverted by these efforts. Furthermore, if we are found to be in violation of any federal or state fraud and abuse laws, we could be subject to civil and criminal penalties, and we could be excluded from participating in federal and state healthcare programs such as Medicare and Medicaid. The occurrence of any

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of these events could give our customers the right to terminate our managed service contracts with them and result in significant harm to our business and financial condition.

The federal healthcare anti-kickback law prohibits any person or entity from offering, paying, soliciting or receiving anything of value, directly or indirectly, for the referral of patients covered by Medicare, Medicaid and other federal healthcare programs or the leasing, purchasing, ordering or arranging for or recommending the lease, purchase or order of any item, good, facility or service covered by these programs. Many states have adopted similar prohibitions against kickbacks and other practices that are intended to induce referrals, and some of these state laws are applicable to all patients regardless of whether the patient is covered under a governmental health program or private health plan. We seek to structure our business relationships and activities to avoid any activity that could be construed to implicate the federal healthcare anti-kickback law and similar laws. We cannot assure you, however, that our arrangements and activities will be deemed outside the scope of these laws or that increased enforcement activities will not directly or indirectly have an adverse effect on our business, financial condition or results of operations. Any determination by a federal or state agency or court that we have violated any of these laws could subject us to civil or criminal penalties, could require us to change or terminate some portions of our operations or business, could disqualify us from providing services to healthcare providers doing business with government programs, could give our customers the right to terminate our managed service contracts with them and, thus, could have a material adverse effect on our business and results of operations. Moreover, any violations by and resulting penalties or exclusions imposed upon our customers could adversely affect their financial condition and, in turn, have a material adverse effect on our business and results of operations.

There are also numerous federal and state laws that forbid submission of false information or the failure to disclose information in connection with the submission and payment of healthcare provider claims for reimbursement. In particular, the federal False Claims Act, or the FCA, prohibits a person from knowingly presenting or causing to be presented a false or fraudulent claim for payment or approval by an officer, employee or agent of the United States. In addition, the FCA prohibits a person from knowingly making, using, or causing to be made or used a false record or statement material to such a claim. Violations of the FCA may result in treble damages, significant monetary penalties, and other collateral consequences including, potentially, exclusion from participation in federally funded healthcare programs. The scope and implications of the recent amendments to the FCA pursuant to the Fraud Enforcement and Recovery Act of 2009, or FERA, have yet to be fully determined or adjudicated and as a result it is difficult to predict how future enforcement initiatives may impact our business. Pursuant to the healthcare reform legislation enacted in March 2010, a claim that includes items or services resulting from a violation of the federal anti-kickback law constitutes a false or fraudulent claim for purposes of the FCA.

These laws and regulations may change rapidly, and it is frequently unclear how they apply to our business. Errors created by our proprietary applications or services that relate to entry, formatting, preparation or transmission of claim or cost report information may be determined or alleged to be in violation of these laws and regulations. Any failure of our proprietary applications or services to comply with these laws and regulations could result in substantial civil or criminal liability and could, among other things, adversely affect demand for our services, invalidate all or portions of some of our managed service contracts with our customers, require us to change or terminate some portions of our business, require us to refund portions of our base fee revenues and incentive payment revenues, cause us to be disqualified from serving customers doing business with government payers, and give our customers the right to terminate our managed service contracts with them, any one of which could have an adverse effect on our business.

***Our failure to comply with debt collection and consumer credit reporting regulations could subject us to fines and other liabilities, which could harm our reputation and business.***

The U.S. Fair Debt Collection Practices Act, or FDCPA, regulates persons who regularly collect or attempt to collect, directly or indirectly, consumer debts owed or asserted to be owed to another person. Certain of our accounts receivable activities may be subject to the FDCPA. Many states impose additional requirements on debt collection communications, and some of those requirements may be more stringent than the comparable federal requirements. Moreover, regulations governing debt collection are subject to changing

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interpretations that may be inconsistent among different jurisdictions. We are also subject to the Fair Credit Reporting Act, or FCRA, which regulates consumer credit reporting and which may impose liability on us to the extent that the adverse credit information reported on a consumer to a credit bureau is false or inaccurate. We could incur costs or could be subject to fines or other penalties under the FCRA if the Federal Trade Commission determines that we have mishandled protected information. We or our customers could be required to report such breaches to affected consumers or regulatory authorities, leading to disclosures that could damage our reputation or harm our business, financial position and operating results.

### *Potential additional regulation of the disclosure of health information outside the United States may increase our costs.*

Federal or state governmental authorities may impose additional data security standards or additional privacy or other restrictions on the collection, use, transmission and other disclosures of health information. Legislation has been proposed at various times at both the federal and the state levels that would limit, forbid or regulate the use or transmission of medical information pertaining to U.S. patients outside of the United States. Such legislation, if adopted, may render our operations in India impracticable or substantially more expensive. Moving such operations to the United States may involve substantial delay in implementation and increased costs.

## **Risks Related to Intellectual Property**

### *We may be unable to adequately protect our intellectual property.*

Our success depends, in part, upon our ability to establish, protect and enforce our intellectual property and other proprietary rights. If we fail to establish or protect our intellectual property rights, we may lose an important advantage in the market in which we compete. We rely upon a combination of patent, trademark, copyright and trade secret law and contractual terms and conditions to protect our intellectual property rights, all of which provide only limited protection. We cannot assure you that our intellectual property rights are sufficient to protect our competitive advantages. Although we have filed six U.S. patent applications, we cannot assure you that any patents that will be issued from these applications will provide us with the protection that we seek or that any future patents issued to us will not be challenged, invalidated or circumvented. We have also been issued one U.S. patent, but we cannot assure you that it will provide us with the protection that we seek or that it will not be challenged, invalidated or circumvented. Legal standards relating to the validity, enforceability and scope of protection of patents are uncertain. Any patents that may be issued in the future from pending or future patent applications or our one issued patent may not provide sufficiently broad protection or they may not prove to be enforceable in actions against alleged infringers. Also, we cannot assure you that any trademark registrations will be issued for pending or future applications or that any of our trademarks will be enforceable or provide adequate protection of our proprietary rights.

We also rely in some circumstances on trade secrets to protect our technology. Trade secrets may lose their value if not properly protected. We endeavor to enter into non-disclosure agreements with our employees, customers, contractors and business partners to limit access to and disclosure of our proprietary information. The steps we have taken, however, may not prevent unauthorized use of our technology, and adequate remedies may not be available in the event of unauthorized use or disclosure of our trade secrets and proprietary technology. Moreover, others may reverse engineer or independently develop technologies that are competitive to ours or infringe our intellectual property.

Accordingly, despite our efforts, we may be unable to prevent third parties from infringing or misappropriating our intellectual property and using our technology for their competitive advantage. Any such infringement or misappropriation could have a material adverse effect on our business, results of operations and financial condition. Monitoring infringement of our intellectual property rights can be difficult and costly, and enforcement of our intellectual property rights may require us to bring legal actions against infringers. Infringement actions are inherently uncertain and therefore may not be successful, even when our rights have been infringed, and even if successful may require a substantial amount of resources and divert our management's attention.

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*Claims by others that we infringe their intellectual property could force us to incur significant costs or revise the way we conduct our business.*

Our competitors protect their intellectual property rights by means such as patents, trade secrets, copyrights and trademarks. We have not conducted an independent review of patents issued to third parties. Additionally, because patent applications in the United States and many other jurisdictions are kept confidential for 18 months before they are published, we may be unaware of pending patent applications that relate to our proprietary technology. Although we have not been involved in any litigation related to intellectual property rights of others, from time to time we receive letters from other parties alleging, or inquiring about, possible breaches of their intellectual property rights. Any party asserting that we infringe its proprietary rights would force us to defend ourselves, and possibly our customers, against the alleged infringement. These claims and any resulting lawsuit, if successful, could subject us to significant liability for damages and invalidation of our proprietary rights or interruption or cessation of our operations. The software and technology industries are characterized by the existence of a large number of patents, copyrights, trademarks and trade secrets and by frequent litigation based on allegations of infringement or other violations of intellectual property rights. Moreover, the risk of such a lawsuit will likely increase as our size and scope of our services and technology platforms increase, as our geographic presence and market share expand and as the number of competitors in our market increases. Any such claims or litigation could:

- be time-consuming and expensive to defend, whether meritorious or not;
- require us to stop providing the services that use the technology that infringes the other party's intellectual property;
- divert the attention of our technical and managerial resources;
- require us to enter into royalty or licensing agreements with third parties, which may not be available on terms that we deem acceptable, if at all;
- prevent us from operating all or a portion of our business or force us to redesign our services and technology platforms, which could be difficult and expensive and may make the performance or value of our service offerings less attractive;
- subject us to significant liability for damages or result in significant settlement payments; or
- require us to indemnify our customers as we are required by contract to indemnify some of our customers for certain claims based upon the infringement or alleged infringement of any third party's intellectual property rights resulting from our customers' use of our intellectual property.

Intellectual property litigation can be costly. Even if we prevail, the cost of such litigation could deplete our financial resources. Litigation is also time-consuming and could divert management's attention and resources away from our business. Furthermore, during the course of litigation, confidential information may be disclosed in the form of documents or testimony in connection with discovery requests, depositions or trial testimony. Disclosure of our confidential information and our involvement in intellectual property litigation could materially adversely affect our business. Some of our competitors may be able to sustain the costs of complex intellectual property litigation more effectively than we can because they have substantially greater resources. In addition, any uncertainties resulting from the initiation and continuation of any litigation could significantly limit our ability to continue our operations and could harm our relationships with current and prospective customers. Any of the foregoing could disrupt our business and have a material adverse effect on our operating results and financial condition.

**Risks Related to the Ownership of Shares of Our Common Stock**

*Anti-takeover provisions in our charter documents and Delaware law could discourage, delay or prevent a change in control of our company and may affect the trading price of our common stock.*

We are a Delaware corporation and the anti-takeover provisions of the Delaware General Corporation Law may discourage, delay or prevent a change in control by prohibiting us from engaging in a business



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combination with an interested stockholder for a period of three years after the person becomes an interested stockholder, even if a change in control would be beneficial to our existing stockholders. In addition, our restated certificate of incorporation and amended and restated bylaws may discourage, delay or prevent a change in our management or control over us that stockholders may consider favorable. Our restated certificate of incorporation and amended and restated bylaws:

- authorize the issuance of “blank check” preferred stock that could be issued by our board of directors to thwart a takeover attempt;
- provide for a classified board of directors, as a result of which the successors to the directors whose terms have expired will be elected to serve from the time of election and qualification until the third annual meeting following their election;
- require that directors only be removed from office for cause and only upon a supermajority stockholder vote;
- provide that vacancies on the board of directors, including newly created directorships, may be filled only by a majority vote of directors then in office;
- limit who may call special meetings of stockholders;
- prohibit stockholder action by written consent, requiring all actions to be taken at a meeting of the stockholders; and
- require supermajority stockholder voting to effect certain amendments to our restated certificate of incorporation and amended and restated bylaws.

For additional information regarding these and other anti-takeover provisions, see “Description of Capital Stock — Anti-Takeover Effects of Our Charter and Bylaws and Delaware Law”.

### *We do not anticipate paying any cash dividends on our capital stock in the foreseeable future.*

Although we paid cash dividends on our capital stock in July 2008 and September 2009, we do not expect to pay cash dividends on our common stock in the foreseeable future. Any future dividend payments will be within the discretion of our board of directors and will depend on, among other things, our financial condition, results of operations, capital requirements, capital expenditure requirements, contractual restrictions, provisions of applicable law and other factors that our board of directors may deem relevant. In addition, our revolving credit facility does not permit us to pay dividends without the lender’s prior consent. We may not generate sufficient cash from operations in the future to pay dividends on our common stock. See “Dividend Policy”.

### **Item 1B. Unresolved Staff Comments**

None.

### **Item 2. Properties**

We do not own any real estate property and lease our existing facilities.

As of December 31, 2010, our corporate headquarters occupy approximately 50,000 square feet in Chicago, Illinois under a lease expiring as to certain portions of the space in 2014 and other portions in 2020. In addition, we have a right of first offer to lease an additional 11,100 square feet of space on another floor in the same building.

In August 2010, we also leased approximately 44,500 square feet of office space in another building in Chicago for a period of 11 years. The total rental commitment under the lease is approximately \$8.0 million. Our other leased facilities are in Kalamazoo, Michigan; Detroit, Michigan; Jupiter, Florida; Cape Girardeau, Missouri; and near New Delhi, India. Pursuant to our master services agreement with Ascension Health and the managed service contracts between us and our customers, we occupy space on-site at all hospitals where

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we provide our revenue cycle management services. We do not pay customers for our use of space provided by them. In general, we are not permitted to provide services to one customer from another customer's site.

We believe that our current facilities are sufficient for our current needs. We intend to add new facilities or expand existing facilities as we add employees or expand our geographic markets, and we believe that suitable additional or substitute space will be available as needed to accommodate any such expansion of our operations.

**Item 3. Legal Proceedings**

From time to time, we have been and may again become involved in legal or regulatory proceedings arising in the ordinary course of our business. We are not presently a party to any material litigation or regulatory proceeding and we are not aware of any pending or threatened litigation or regulatory proceeding against us that could have a material adverse effect on our business, operating results, financial condition or cash flows.

**PART II****Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuers Purchases of Equity Securities**

Our common stock has traded on the New York Stock Exchange, or NYSE, under the symbol "AH" since May 20, 2010. Prior to that time, there was no public market for our common stock. The following table sets forth the high and low intraday sales prices per share of our common stock, as reported by the NYSE, for the periods indicated.

|                                  | Price Range |         |
|----------------------------------|-------------|---------|
|                                  | High        | Low     |
| <b>2010</b>                      |             |         |
| Quarter ended June 30, 2010(1)   | \$15.21     | \$12.53 |
| Quarter ended September 30, 2010 | \$13.34     | \$ 9.05 |
| Quarter ended December 31, 2010  | \$16.25     | \$ 8.30 |

(1) Our common stock began trading on May 20, 2010.

The closing sale price per share of our common stock, as reported by the NYSE, on March 16, 2011 was \$24.25. As of February 28, 2011 there were 79 holders of record for our common stock.

**Dividend Policy**

We declared a cash dividend in the aggregate amount of \$15.0 million, or \$0.18 per common-equivalent share, to holders of record as of July 11, 2008 of our common stock and preferred stock. We declared an additional cash dividend in the aggregate amount of \$14.9 million, or \$0.18 per common equivalent share, to holders of record as of September 1, 2009 of our common stock and preferred stock. We declared no cash dividends in 2010.

We currently intend to retain earnings, if any, to finance the growth and development of our business, and we do not expect to pay any cash dividends on our common stock in the foreseeable future. Payment of future dividends, if any, will be at the discretion of our board of directors and will depend on our financial condition, results of operations, capital requirements, restrictions contained in current or future financing instruments, provisions of applicable law, and other factors the board deems relevant. Our \$15 million revolving line of credit agreement does not permit us to pay any future dividends without the lender's prior consent.

**Equity Compensation Plan Information**

The Company maintains a 2006 Second Amended and Restated Stock Option Plan (the "2006 Plan"). In April 2010, the Company adopted a new 2010 Stock Incentive Plan (the "2010 Plan"), which became effective immediately prior to the closing of the IPO. The Company will not make any further grants under the 2006

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Plan, and the 2010 Plan provides for the grant of incentive stock options, non-statutory stock options, restricted stock awards and other stock-based awards. As of December 31, 2010, an aggregate of 15,749,404 shares were subject to outstanding options under both plans, and 8,054,762 shares were available for grant. However, to the extent that previously granted awards under the 2006 Plan or 2010 Plan expire, terminate or are otherwise surrendered, cancelled, forfeited or repurchased by the Company, the number of shares available for future awards will increase, up to a maximum of 24,374,756 shares.

The information regarding securities authorized for issuance under the Company's stock option plans is set forth below, as of December 31, 2010:

| <u>Plan</u>                                 | <u>Number of Securities to be Issued Upon Exercise of Outstanding Options</u> | <u>Weighted-Average Exercise Price of Outstanding Options</u> | <u>Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans</u> |
|---|---|---|---|
| 2006 Amended and Restated Stock Option Plan | 15,459,090  | \$ 9.41   | —   |
| 2010 Stock Incentive Plan                   | 290,314   | 11.57   | 8,054,762   |
| Total                                       | 15,749,404  | \$ 9.45   | 8,054,762   |

## **Sales of Unregistered Securities and Use of Proceeds**

### *Use of Proceeds from Initial Public Offering*

The SEC declared the Registration Statement on Form S-1 (File No. 333-162186) related to our initial public offering effective on May 19, 2010. In the offering, which commenced on May 20, 2010 and closed on May 25, 2010, we registered 11,500,000 shares of our common stock at a price to the public of \$12.00 per share. We sold 7,666,667 of the shares of our common stock in the offering, and the selling stockholders sold 3,833,333 shares. Goldman, Sachs & Co. and Credit Suisse Securities (USA) LLC were the joint book-running managers and representatives of the underwriters. The offering generated gross proceeds to us of \$92.0 million, or \$80.8 million net of underwriting discounts and offering expenses. The offering generated gross proceeds to the selling stockholders of \$46.0 million, or \$43.2 million net of underwriting discounts. We incurred \$7.1 million of offering-related expenses, of which \$2.9 million were incurred prior to December 31, 2009. Out of \$7.1 million of offering expenses, \$1.4 million was satisfied through the issuance of 115,000 shares of common stock to Financial Technology Partners LP and/or FTP Securities LLC in satisfaction of a fee for advisory services in respect of the initial public offering. Additionally, in conjunction with the offering, we issued 1,265,012 shares and paid \$0.9 million in satisfaction of liquidation preference payments due to preferred shareholders, including certain directors, officers and their affiliates.

From the effective date of the registration statement through December 31, 2010, we did not use any of our proceeds from our initial public offering. There has been no change in the planned use of proceeds from the initial public offering as described in our Registration Statement on Form S-1 declared effective by the SEC on May 19, 2010.

### *Unregistered Sales of Equity Securities*

Set forth below is information regarding our issuances of capital stock and our grants of warrants and options to purchase shares of capital stock, which were not registered under the Securities Act, since January 1, 2006. Also included is the consideration, if any, received by us for such shares, warrants and options and information relating to the section of the Securities Act, or rule of the Securities and Exchange Commission, under which exemption from registration was claimed.

#### *(a) Issuances of Capital Stock*

(1) In May 2006, we issued an aggregate of 391,079 shares of non-voting common stock, valued at \$1.34 per share (based on the estimated fair value of the shares on that date) for an aggregate value of \$524,764, to a total of 15 former stockholders of SureDecisions, Inc. in connection with our acquisition of SureDecisions in May 2006. In June 2007, we issued an aggregate of 156,432 additional shares of non-voting common stock,

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valued at \$2.09 per share (based on the estimated fair value of the shares on that date) for an aggregate value of \$327,229, as earn-out consideration to the former stockholders of SureDecisions.

(2) In May 2007, we issued 2,623,593 shares of voting common stock to Ascension Health at a price of \$2.09 per share for a total purchase price of \$5,488,128.

(3) In December 2008, we issued an aggregate of 12,975,007 shares of voting common stock in exchange for 12,975,007 shares of non-voting common stock held by a total of 10 of our directors, officers and their affiliates. These shares are subject to the terms and conditions set forth in our restricted stock plan, the restricted stock award agreements entered into between us and our stockholders in connection with the original issuance of the shares of non-voting common stock and our stockholders' agreement pursuant to which these persons have certain registration rights.

No underwriters were involved in the foregoing issuances of securities. The shares of common stock described in paragraphs (a)(1) and (a)(2) of Item 15 were issued in reliance upon the exemption from the registration requirements of the Securities Act provided by Section 4(2) of the Securities Act as sales by an issuer not involving any public offering. The shares of common stock described in paragraph (a)(3) of Item 15 were issued in exchange for shares of our non-voting common stock held by our existing stockholders exclusively, with no other consideration, commission or other remuneration paid or given directly or indirectly for soliciting such exchange, in reliance upon the exemption from the registration requirements of the Securities Act provided by Section 3(a)(9).

### *(b) Warrant Grants and Exercises*

Since January 1, 2006, we granted warrants to Ascension Health to purchase an aggregate of 3,040,018 shares of voting common stock with exercise prices ranging from \$0.003 per share to \$13.02 per share. Of these warrants, 1,749,064 were issued to Ascension Health based upon the achievement of specified milestones relating to sales and marketing assistance that it provided to us. Since January 1, 2006, Ascension Health purchased an aggregate of 1,290,954 shares of voting common stock upon warrant exercises for aggregate consideration of \$3,293. In connection with our initial public offering in May 2010, we issued 615,649 shares of common stock to Ascension Health upon its cashless exercise of outstanding supplemental warrants.

In December 2010, we issued 3,266,668 shares of the common stock upon the exercise of a warrant for aggregate consideration of \$933,334.

The warrants and shares of voting common stock issued upon the exercise of the warrants described in this paragraph (b) of Item 15 were issued in reliance upon the exemption from the registration requirements of the Securities Act provided by Section 4(2) of the Securities Act as sales by an issuer not involving any public offering.

### *(c) Option Grants and Exercises*

Since January 1, 2006, we granted options to purchase an aggregate of 17,279,166 shares of non-voting common stock, with exercise prices ranging from \$0.80 to \$14.96 per share, to employees, directors and consultants pursuant to our stock option plan. Since January 1, 2006, we issued an aggregate of 3,394,582 shares of non-voting common stock upon exercise of unvested options for aggregate consideration of \$2,587,593 and 1,251,283 shares of non-voting common stock upon exercise of vested options for aggregate consideration of \$701,717. Our prior option plan permits the exercise of unvested options; until vested, shares issued upon exercise of unvested options remain subject to our right of repurchase.

The options and shares of non-voting common stock issuable upon the exercise of the options described in this paragraph (c) of Item 15 were issued pursuant to written compensatory plans or arrangements with our employees, directors and consultants in reliance upon the exemption from the registration requirements of the Securities Act provided by Rule 701 promulgated under the Securities Act. All recipients of options and shares pursuant to this exemption either received adequate information about us or had access, through employment or other relationships, to such information. In some cases, the options and shares of non-voting common stock

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issuable upon the exercise of the options described in this paragraph (c) of Item 15 were issued in reliance upon the exemption from the registration requirements of the Securities Act provided by Section 4(2) of the Securities Act as sales by an issuer not involving any public offering.

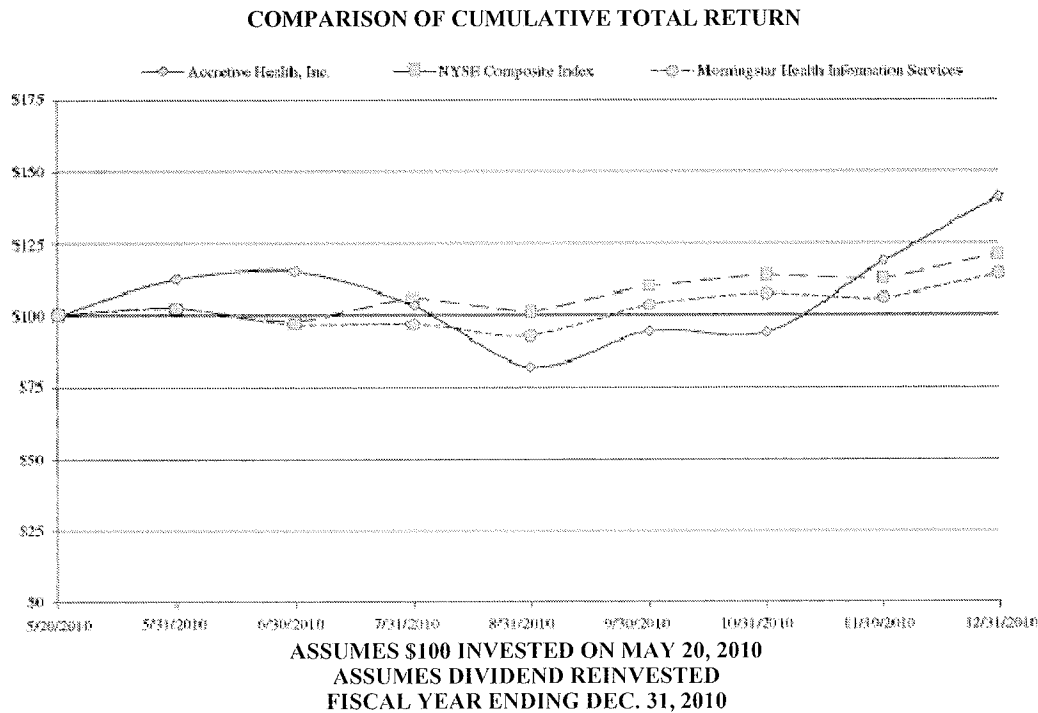
All of the foregoing securities are deemed restricted securities for purposes of the Securities Act. All certificates representing the issued shares of voting common stock and non-voting common stock described in paragraphs (a), (b) and (c) of Item 15 included appropriate legends setting forth that the securities had not been registered and the applicable restrictions on transfer.

### (d) Issuance of Shares for Financial Advisory Services

Contemporaneously with the closing of our initial public offering in May 2010, we issued shares of common stock to Financial Technology Partners LP and/or FTP Securities LLC in partial payment of a fee due for financial advisory services provided in connection with that offering. The issuance of shares to Financial Technology Partners LP and/or FTP Securities LLC was exempt from registration under Section 4(2) of the Securities Act.

### Stock Price Performance Graph

The following graph compares the change in the cumulative total return (including the reinvestment of dividends) on our common stock for the period from May 20, 2010, the date our shares of common stock began trading on the NYSE, to the change in the cumulative total return on the stocks included in the NYSE Composite Index and Morningstar Healthcare Services Index over the same period. The graph assumes an investment of \$100 made in our common stock at a price of \$12.00 per share, the opening sale price on May 20, 2010, our first day of trading following our IPO, and an investment in each of the other indices on May 20, 2010. We did not pay any dividends during the period reflected in the graph.



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| Company/Market/Peer Group               | 5/20/2010 | 5/31/2010 | 6/30/2010 | 7/31/2010 | 8/31/2010 | 9/30/2010 | 10/31/2010 | 11/30/2010 | 12/31/2010 |
|---|-----------|-----------|-----------|-----------|-----------|-----------|------------|------------|------------|
| Accretive Health, Inc.                  | \$100.00  | \$112.92  | \$115.18  | \$103.51  | \$ 81.92  | \$ 94.29  | \$ 93.85   | \$119.18   | \$141.47   |
| NYSE Composite Index                    | \$100.00  | \$102.19  | \$ 97.50  | \$105.63  | \$101.42  | \$110.34  | \$113.99   | \$113.02   | \$121.30   |
| Morningstar Health Information Services | \$100.00  | \$102.34  | \$ 96.64  | \$ 96.91  | \$ 92.94  | \$103.60  | \$107.37   | \$106.00   | \$114.83   |

The comparisons shown in the graph above are based on historical data and we caution that the stock price performance shown in the graph above is not indicative of, and is not intended to forecast, the potential future performance of our common stock. The information in this "Performance Graph" section shall not be deemed to be "soliciting material" or to be "filed" with the SEC, nor shall such information be incorporated by reference into any future filing under the Securities Act of 1933 or the Securities Exchange Act of 1934, except to the extent that we specifically incorporate it by reference into such filing.

### Item 6. Selected Consolidated Financial Data

The following tables summarize our consolidated financial data for the periods presented. You should read the following selected consolidated financial data in conjunction with our financial statements and the related notes appearing at the end of this Annual Report on Form 10-K and the "Management's Discussion and Analysis of Financial Condition and Results of Operations" section of this Annual Report on Form 10-K.

We derived the statement of operations data for the years ended December 31, 2008, 2009 and 2010 and the balance sheet data as of December 31, 2009 and 2010 from our audited consolidated financial statements, which are included in this Annual Report on Form 10-K. We derived the statement of operations data for the years ended December 31, 2006 and 2007 and the balance sheet data as of December 31, 2006, 2007 and 2008 from our audited consolidated financial statements, which are not included in this Annual Report on Form 10-K.

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|   | Year Ended December 31,                         |            |            |            |            |
|---|---|------------|------------|------------|------------|
|   | 2006  | 2007       | 2008       | 2009       | 2010       |
|   | (In thousands, except share and per share data) |            |            |            |            |
| <b>Statement of Operations Data:</b>  |   |            |            |            |            |
| Net services revenue  | \$ 160,741                                      | \$ 240,725 | \$ 398,469 | \$ 510,192 | \$ 606,294 |
| Costs of services   | 141,767   | 197,676    | 335,211    | 410,711    | 478,276    |
| Operating margin  | 18,974  | 43,049     | 63,258     | 99,481     | 128,018    |
| Operating expenses:   |   |            |            |            |            |
| Infused management and technology   | 18,875  | 27,872     | 39,234     | 51,763     | 64,029     |
| Selling, general and administrative   | 8,777   | 15,657     | 21,227     | 30,153     | 41,671     |
| Total operating expenses  | 27,652  | 43,529     | 60,461     | 81,916     | 105,700    |
| Income (loss) from operations   | (8,678)   | (480)      | 2,797      | 17,565     | 22,318     |
| Net interest income (expense)(1)  | 1,359   | 1,710      | 710        | (9)        | 29         |
| Income (loss) before provision for income taxes                               | (7,319)   | 1,230      | 3,507      | 17,556     | 22,347     |
| Provision for income taxes  | —   | 456        | 2,264      | 2,966      | 9,729      |
| Net income (loss)   | \$ (7,319)                                      | \$ 774     | \$ 1,243   | \$ 14,590  | \$ 12,618  |
| Net income (loss) per common share:   |   |            |            |            |            |
| Basic:  | \$ (0.28)                                       | \$ 0.01    | \$ (0.19)  | \$ 0.17    | \$ 0.18    |
| Diluted:  | (0.28)  | 0.01       | (0.19)     | 0.15       | 0.13       |
| Weighted-average shares used in computing net income (loss) per common share: |   |            |            |            |            |
| Basic:  | 25,918,942                                      | 32,968,085 | 36,122,470 | 36,725,194 | 70,732,791 |
| Diluted:  | 25,918,942                                      | 40,360,362 | 36,122,470 | 43,955,167 | 94,206,677 |
| <b>Other Operating Data (unaudited):</b>                                      |   |            |            |            |            |
| Adjusted EBITDA(2)  | \$ (7,125)                                      | \$ 6,842   | \$ 12,220  | \$ 32,912  | \$ 45,024  |

|   | As of December 31, |                |                |                |                |
|---|--------------------|----------------|----------------|----------------|----------------|
|   | 2006               | 2007           | 2008           | 2009           | 2010           |
|   | (In millions)      |                |                |                |                |
| Projected contracted annual revenue run rate(3) | \$200 to \$204     | \$309 to \$315 | \$421 to \$430 | \$509 to \$519 | \$698 to \$713 |

|                            | As of December 31, |          |          |           |           |
|----------------------------|--------------------|----------|----------|-----------|-----------|
|                            | 2006               | 2007     | 2008     | 2009      | 2010      |
|                            | (In thousands)     |          |          |           |           |
| <b>Balance Sheet Data:</b> |                    |          |          |           |           |
| Cash and cash equivalents  | \$20,782           | \$34,745 | \$51,656 | \$ 43,659 | \$155,573 |
| Working capital            | (2,445)            | 8,010    | (3,453)  | (4,122)   | 109,757   |
| Total assets               | 27,333             | 60,858   | 86,904   | 103,472   | 262,619   |
| Total stockholders' equity | \$ 3,166           | \$15,910 | \$ 7,923 | \$ 21,279 | 142,719   |

(1) Interest income results from earnings associated with our cash and cash equivalents. Interest income declined subsequent to 2007 due to reductions in market interest rates. No debt or other interest-bearing obligations were outstanding during any of the periods presented. Interest expense for 2009 is a result of a

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\$150 origination fee paid in connection with establishing our new revolving line of credit and has been shown net of interest income earned during the year.

- (2) We define adjusted EBITDA as net income (loss) before net interest income (expense), income tax expense (benefit), depreciation and amortization expense and share-based compensation expense. Adjusted EBITDA is a non-GAAP financial measure and should not be considered as an alternative to net income, operating income and any other measure of financial performance calculated and presented in accordance with GAAP.

We believe adjusted EBITDA is useful to investors in evaluating our operating performance for the following reasons:

- adjusted EBITDA and similar non-GAAP measures are widely used by investors to measure a company's operating performance without regard to items that can vary substantially from company to company depending upon financing and accounting methods, book values of assets, capital structures and the methods by which assets were acquired;
- securities analysts often use adjusted EBITDA and similar non-GAAP measures as supplemental measures to evaluate the overall operating performance of companies; and
- by comparing our adjusted EBITDA in different historical periods, our investors can evaluate our operating results without the additional variations of interest income (expense), income tax expense (benefit), depreciation and amortization expense and share-based compensation expense.

Our management uses adjusted EBITDA:

- as a measure of operating performance, because it does not include the impact of items that we do not consider indicative of our core operating performance;
- for planning purposes, including the preparation of our annual operating budget;
- to allocate resources to enhance the financial performance of our business;
- to evaluate the effectiveness of our business strategies; and
- in communications with our board of directors and investors concerning our financial performance.

We understand that, although measures similar to adjusted EBITDA are frequently used by investors and securities analysts in their evaluation of companies, adjusted EBITDA has limitations as an analytical tool, and you should not consider it in isolation or as a substitute for analysis of our results of operations as reported under GAAP. Some of these limitations are:

- adjusted EBITDA does not reflect our cash expenditures or future requirements for capital expenditures or other contractual commitments;
- adjusted EBITDA does not reflect changes in, or cash requirements for, our working capital needs;
- adjusted EBITDA does not reflect share-based compensation expense;
- adjusted EBITDA does not reflect cash requirements for income taxes;
- adjusted EBITDA does not reflect net interest income (expense); and
- other companies in our industry may calculate adjusted EBITDA differently than we do, limiting its usefulness as a comparative measure.

To properly and prudently evaluate our business, we encourage you to review the GAAP financial statements included elsewhere in this Annual Report on Form 10-K, and not to rely on any single financial measure to evaluate our business.



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The following table presents a reconciliation of adjusted EBITDA to net income, the most comparable GAAP measure:

|                                       | Year Ended December 31, |          |          |          |          |
|---------------------------------------|-------------------------|----------|----------|----------|----------|
|                                       | 2006                    | 2007     | 2008     | 2009     | 2010     |
|                                       | (In thousands)          |          |          |          |          |
| Net income (loss)                     | \$(7,319)               | \$ 774   | \$ 1,243 | \$14,590 | \$12,618 |
| Net interest (income) expense(a)      | (1,359)                 | (1,710)  | (710)    | 9        | (29)     |
| Provision for income taxes            | —                       | 456      | 2,264    | 2,966    | 9,729    |
| Depreciation and amortization expense | 626                     | 1,307    | 2,540    | 3,921    | 6,157    |
| EBITDA                                | \$(8,052)               | \$ 827   | \$ 5,337 | \$21,486 | \$28,475 |
| Stock compensation expense(b)         | 844                     | 934      | 3,551    | 6,917    | 16,549   |
| Stock warrant expense(b)              | 83                      | 5,081    | 3,332    | 4,509    | —        |
| Adjusted EBITDA                       | \$(7,125)               | \$ 6,842 | \$12,220 | \$32,912 | \$45,024 |

(a) See footnote 1 above.

(b) Stock compensation expense and stock warrant expense collectively represent the share-based compensation expense reflected in our financial statements. Of the amounts presented above, \$928, \$921 and \$1,736 was classified as a reduction in net services revenue for the years ended December 31, 2007, 2008 and 2009, respectively. No such reduction was recorded for the year ended December 31, 2010 as all warrants had been earned and therefore there was no stock warrant expense.

(3) We define our projected contracted annual revenue run rate as the expected total net services revenue for the subsequent 12 months for all healthcare providers for which we are providing services under contract. We believe that our projected contracted annual revenue run rate is a useful method to measure our overall business volume at a point in time and changes in the volume of our business over time because it eliminates the timing impact associated with the signing of new contracts during a specific quarterly or annual period. Actual revenues may differ from the projected amounts used for purposes of calculating projected contracted annual revenue run rate because, among other factors, the scope of services provided to existing customers may change and the incentive fees we earn may be more or less than expected depending on our ability to achieve projected increases in our customers' net revenue yield and projected reductions in the total medical cost of the customer's patient populations. See "Management's Discussion and Analysis of Financial Condition and Results of Operations — Overview — Our Background" for more information.

## Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

*You should read the following discussion and analysis of our financial condition and results of operations together with our financial statements and the related notes and other financial information included elsewhere in this Annual Report on Form 10-K. Some of the information contained in this discussion and analysis or set forth elsewhere in this Annual Report on Form 10-K, including information with respect to our plans and strategy for our business and related financing, includes forward-looking statements that involve risks and uncertainties. You should review the "Risk Factors" section of this Annual Report on Form 10-K for a discussion of important factors that could cause actual results to differ materially from the results described in or implied by the forward-looking statements contained in the following discussion and analysis.*

### Overview

#### Our Background

Accretive Health is a leading provider of services that help healthcare providers generate sustainable improvements in their operating margins and healthcare quality while also improving patient, physician and staff satisfaction. Our core service offering helps U.S. healthcare providers to more efficiently manage their revenue cycles, which encompass patient registration, insurance and benefit verification, medical treatment documentation and coding, bill preparation and collections. Our quality and total cost of care service offering,

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introduced in 2010, can enable healthcare providers to effectively manage the health of a defined patient population, which we believe is a future direction of the manner in which healthcare services will be delivered in the United States.

At December 31, 2010 we provided our integrated revenue cycle service offering to 26 customers representing 66 hospitals as well as physician billing organizations associated with several of these customers, and our quality and total cost of care service offering to one of these customers, representing seven hospitals and 42 clinics.

Our integrated revenue cycle technology and services offering spans the entire revenue cycle. We help our revenue cycle customers increase the portion of the maximum potential patient revenue they receive, while reducing total revenue cycle costs. Our quality and total cost of care solution can help our customers identify the individuals who are most likely to experience an adverse health event and, as a result, incur high healthcare costs in the coming year. This data allows providers to focus greater efforts on managing these patients within and across the delivery system, as well as at home.

Our customers typically are multi-hospital systems, including faith-based or community healthcare systems, academic medical centers and independent ambulatory clinics, and their affiliated physician practice groups. To implement our solutions, we assume full responsibility for the management and cost of the operations we have contracted to manage and supplement the customer's existing staff involved in such operations with seasoned Accretive Health personnel. A customer's revenue improvements and cost savings generally increase over time as we deploy additional programs and as the programs we implement become more effective, which in turn provides visibility into our future revenue and profitability. In 2010, for example, approximately 87% of our net services revenue, and nearly all of our net income, was derived from customer contracts that were in place as of January 1, 2010.

Our revenue cycle management services customers have historically achieved significant net revenue yield improvements within 18 to 24 months of implementing our solution, with such customers operating under mature managed service contracts typically realizing 400 to 600 basis points in yield improvements in the third or fourth contract year. All of a customer's yield improvements during the period we are providing services are attributed to our solution because we assume full responsibility for the management of the customer's revenue cycle. Our methodology for measuring yield improvements excludes the impact of external factors such as changes in reimbursement rates from payors, the expansion of existing services or addition of new services, volume increases and acquisitions of hospitals or physician practices, which may impact net revenue but are not considered changes to net revenue yield.

We and our customers share financial gains resulting from our solutions, which directly aligns our objectives and interests with those of our customers. Both we and our customers benefit — on a contractually agreed-upon basis — from net revenue increases realized by the customers as a result of our services. To date, we have experienced a contract renewal rate of 100% (excluding exploratory new service offerings, a consensual termination following a change of control and a customer reorganization). Coupled with the long-term nature of our managed service contracts and the fixed nature of the base fees under each contract, our historical renewal experience provides a core source of recurring revenue.

We believe that current macroeconomic conditions will continue to impose financial pressure on healthcare providers and will increase the importance of managing their operations effectively and efficiently. Additionally, the continued operating pressures facing U.S. hospitals coupled with some of the underlying themes of healthcare reform legislation enacted in March 2010 make the efficient management of the revenue cycle, including collection of the full amount of payments due for patient services, and quality and total cost of care initiatives, among the most critical challenges facing healthcare providers today.

Our corporate headquarters are located in Chicago, Illinois, and we operate shared services centers and offices in Michigan, Illinois, Missouri, Florida and India. As of December 31, 2010, we had 1,991 full-time employees and 231 part-time employees, and managed approximately 8,200 of our customers' employees who are involved in patient registration, health management information, procedure coding, billing and collections.

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We refer to these functions collectively as the revenue cycle, and to the personnel involved in a customer's revenue cycle as revenue cycle staff.

In evaluating our business performance, our management monitors various financial and non-financial metrics. On a monthly basis, our chief executive officer, chief financial officer and other senior leaders monitor our projected contracted annual revenue run rate (as described below), net patient revenue under management, aggregate net services revenue, revenue cycle operating costs, corporate-level operating expenses, cash flow and adjusted EBITDA. When appropriate, decisions are made regarding action steps to improve these overall operational measures. Our senior operational leaders also monitor the performance of each customer's revenue cycle or quality and total cost of care operations through ten to twelve hospital-specific operating reviews each year. Such reviews typically focus on planned and actual operating results being achieved on behalf of our customers, progress against our operating metrics and planned and actual operating costs for that site. During these regular reviews, our senior operational leaders communicate to the operating teams suggestions to improve contract and operations performance and monitor the results of previous efforts. In addition, our senior management also monitors our ability to attract, hire and retain a sufficient number of talented employees to staff our growing business, and the development and performance of our proprietary technology.

We define our projected contracted annual revenue run rate, or PCARRR, as the total net services revenue we expect to receive during the subsequent twelve months from all customers under contract. We report PCARRR as a range as it includes estimates concerning our relative success in achieving incentive based payments over the next 12 months. We believe that PCARRR is a useful method to measure our overall business volume at a point in time and changes in the volume of our business over time because it eliminates the timing impact of contract signings within a specific quarterly or annual period.

By way of example, we generally expect that the annual revenues for our revenue cycle management services at contract maturity (which is generally reached in three and one-half to four years) for a representative hospital customer with \$1 billion in net patient revenues will be approximately 5% of the provider's net patient revenue, or approximately \$50 million, consisting of \$40 million of base fees, net of cost savings shared with the customer, and \$10 million of incentive fees. For the same representative hospital customer for our quality and total cost of care service offering, which we introduced in 2010, we currently expect that the annual revenues will be approximately \$60 million, consisting of up to \$10 million in base fees and up to \$50 million in incentive fees. We generally expect our incentive fees to improve over time as we introduce additional aspects of our operating model and as our predictive analytics improve with additional customer-specific details. Therefore, we generally expect our PCARRR for a specific customer engagement to increase annually until the contract is operating at maturity levels.

## **Seasonality**

Our quarterly and annual net services revenue generally increased each period due to ongoing expansion in the number of hospitals subject to managed service contracts with us and increases in the amount of incentive payments earned. The timing of customer additions is not uniform throughout the year. We also experience fluctuations in incentive payments as a result of patients' ability to accelerate or defer elective procedures, particularly around holidays such as Thanksgiving and Christmas. Generally, incentive payments earned are lower in the first quarter of each year and higher in the fourth quarter of each year. For example, incentive payments in the quarter ended March 31, 2010 were \$12.3 million, or only 61% of the \$20.2 million earned in the quarter ended December 31, 2009. As a result of incentive payment fluctuations, our adjusted EBITDA is typically lower in the first quarter of each fiscal year. For example, our adjusted EBITDA of \$4.4 million for the quarter ended March 31, 2010 represented less than 10% of our \$45.0 million of adjusted EBITDA for the year ended December 31, 2010. We expect this seasonality to continue in our business and we believe that first quarter adjusted EBITDA will average approximately 10% of full fiscal year adjusted EBITDA for the foreseeable future; provided, however, that due to the factors described above, as well as other factors, some of which may be beyond our control, our actual results could differ materially from these estimates.

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### *Net Services Revenue*

We derive our net services revenue primarily from service contracts under which we manage our customers' revenue cycle or quality and total cost of care operations. Revenues from managed service contracts consist of base fees and incentive payments:

- Base fee revenues represent our contractually-agreed annual fees for managing and overseeing our customers' revenue cycle or quality and total cost of care operations. Following a comprehensive review of a customer's operations, the customer's base fees are tailored to its specific circumstances and the extent of the customer's operations for which we are assuming operational responsibility; we do not have standardized fee arrangements.
- Incentive payment revenues for revenue cycle management services represent the amounts we receive by increasing our customers' net patient revenue and identifying potential payment sources for patients who are uninsured and underinsured. These payments are governed by specific formulas contained in the managed service contract with each of our customers. In general, we earn incentive payments by increasing a customer's actual cash yield as a percentage of the contractual amount owed to such customer for the healthcare services provided.
- Incentive payment revenues for quality and total cost of care services will represent our share of the provider community cost savings for our role in providing the technology infrastructure and for managing the care coordination process.

In addition, we earn revenue from other services, which primarily include our share of revenues associated with the collection of dormant patient accounts (more than 365 days old) under some of our service contracts. We also receive revenue from other services provided to customers that are not part of our integrated service offerings, such as procedure-by-procedure fee schedule reviews, physician advisory services or consulting on the billing for individuals receiving emergency room treatment.

Some of our service contracts entitle customers to receive a share of the cost savings we achieve from operating their revenue cycle. This share is returned to customers as a reduction in subsequent base fees. Our services revenue is reported net of cost sharing, and we refer to this as our net services revenue.

The following table summarizes the composition of our net services revenue for the year ended December 31, 2010 on a percentage basis:

|  | Year<br>Ended<br>December 31,<br>2010 |
|--|---------------------------------------|
| Net base fees for managed service contracts      | 86%                                   |
| Incentive payments for managed service contracts | 12%                                   |
| Other services                                   | 2%                                    |
| Total  | <u>100%</u>                           |

Net base fee and incentive payments were exclusively related to our revenue cycle management services in 2010. We were unable to record revenues for the benefits that may have been achieved in our quality and total cost of care services contract as the amounts were not yet sufficiently fixed and determinable to qualify for revenue recognition under our accounting policy. See "Results of Operations" for more information.

### *Costs of Services*

Under our managed service contracts, we assume responsibility for all costs necessary to conduct the customers' revenue cycle or quality and total cost of care operations that we have contracted to manage. Costs of services consist primarily of the salaries and benefits of the customers' employees engaged in activities which are included in our contract and who are managed on-site by us, the salaries and benefits of our employees who are engaged in similar activities, the costs associated with vendors that provide services

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integral to the services we are contracted to manage and the costs associated with operating our shared services centers.

Under our managed service contracts, we assume responsibility for the costs necessary to conduct the customers' revenue cycle or quality and total cost of care operations that we have contracted to manage. Costs of services consist primarily of:

- Salaries and benefits of the customers' employees engaged in activities which are included in our contract and who are assigned to work on-site with us. Under our contracts with our customers, we are responsible for the cost of the salaries and benefits for these employees of our customers. Salaries are paid and benefits are provided to such individuals directly by the customer, instead of adding these individuals to our payroll, because these individuals remain employees of our customers.
- Salaries and benefits of our employees in our shared services centers (these individuals are distinct from on-site "infused management" discussed below) and the non-payroll costs associated with operating our shared service centers.
- Costs associated with vendors that provide services integral to the customer's services we are contracted to manage.

Costs of services were exclusively related to our revenue cycle management services in 2010.

### ***Operating Margin***

Operating margin is equal to net services revenue less costs of services. Our operating model is designed to improve margin under each managed service contract as the contract matures, for several reasons:

- We typically enhance the productivity of a customer's revenue cycle operations over time as we fully implement our technology and procedures and because any overlap between costs of our shared services centers and costs of hospital operations targeted for transition is generally concentrated in the first year of the contract.
- Incentive payments under each managed service contract generally increase over time as we deploy additional programs and the programs we implement become more effective and produce improved results for our customers.

### ***Infused Management and Technology Expenses***

We refer to our management and staff employees that we devote on-site to customer operations as infused management. Infused management and technology expenses consist primarily of the wages, bonuses, benefits, share based compensation, travel and other costs associated with deploying our employees on customer sites to guide and manage our customers' revenue cycle or population health management operations. The employees we deploy on customer sites typically have significant experience in revenue cycle operations, core coordination, technology, quality control or other management disciplines. The other significant portion of these expenses is an allocation of the costs associated with maintaining, improving and deploying our integrated proprietary technology suite and an allocation of the costs previously capitalized for developing our integrated proprietary technology suite.

### ***Selling, General and Administrative Expenses***

Selling, general and administrative expenses consist primarily of expenses for executive, sales, corporate information technology, legal, regulatory compliance, finance and human resources personnel, including wages, bonuses, benefits and share-based compensation; fees for professional services; share-based expense for stock warrants; insurance premiums; facility charges; and other corporate expenses. Professional services consist primarily of external legal, tax and audit services. The costs of developing the processes and technology for our emerging quality and total cost of care service offering prior to November 2010 when we signed our inaugural client are also included in selling, general and administrative expenses. We expect selling, general and administrative expenses to increase in absolute dollars as we continue to add information

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technology, human resources, finance, accounting and other administrative personnel as we expand our business.

We also expect to incur additional professional fees and other expenses resulting from future expansion and the compliance requirements of operating as a public company, including increased audit and legal expenses, investor relations expenses, increased insurance expenses, particularly for directors' and officers' liability insurance, and the costs of complying with Section 404 of the Sarbanes-Oxley Act. While these costs may initially increase as a percentage of our net services revenue, we expect that in the future these expenses will increase at a slower rate than our overall business volume, and that they will eventually represent a smaller percentage of our net services revenue.

Although we cannot predict future changes to the laws and regulations affecting us or the healthcare industry generally, we do not expect that any associated changes to our compliance programs will have a material effect on our selling, general and administrative expenses.

### *Interest Income (Expense)*

Interest income is derived from the return achieved from our cash balances. We invest primarily in highly liquid, short-term investments, primarily those insured by the U.S. government. Interest expense for the year ended December 31, 2009 resulted from origination fees associated with our revolving line of credit, which we entered into on September 30, 2009.

### *Income Taxes*

Income tax expense consists of federal and state income taxes in the United States and India. Although we had net operating loss carryforwards in 2008, our effective tax rate in 2008 was approximately 65%. This was due principally to the fact that a large portion of our operations is conducted in Michigan, which in 2008 began to impose a tax based on gross receipts in addition to tax based on net income. Although we continued to pay the Michigan gross receipts tax in 2009, our effective tax rate declined to approximately 17% in 2009, principally due to the release of \$3.5 million of valuation allowances for deferred tax assets. Our effective tax rate in 2010 was 44% due principally to the gross receipts taxes paid to the State of Michigan and, to a lesser extent, other states. In the summer of 2010, a change in legislation substantially reduced the requirement for us to pay taxes on any future gross receipts in Michigan. We expect our overall effective tax rate to be approximately 40% in future years because we have minimal net operating loss carryforwards and the impact of the various remaining state gross receipts taxes will become less significant in relation to other income-based taxes. We also expect our income tax expense to increase in absolute dollars as our income increases.

### **Application of Critical Accounting Policies and Use of Estimates**

Our consolidated financial statements reflect the assets, liabilities and results of operations of Accretive Health, Inc. and our wholly-owned subsidiaries. All intercompany transactions and balances have been eliminated in consolidation. Our consolidated financial statements have been prepared in accordance with GAAP.

The preparation of financial statements in conformity with GAAP requires us to make estimates and judgments that affect the amounts reported in our consolidated financial statements and the accompanying notes. We regularly evaluate the accounting policies and estimates we use. In general, we base estimates on historical experience and on assumptions that we believe to be reasonable given our operating environment. Estimates are based on our best knowledge of current events and the actions we may undertake in the future. Although we believe all adjustments considered necessary for fair presentation have been included, our actual results may differ materially from our estimates.

We believe that the accounting policies described below involve our more significant judgments, assumptions and estimates and, therefore, could have the greatest potential impact on our consolidated financial statements. In addition, we believe that a discussion of these policies is necessary to understand and evaluate the consolidated financial statements contained in this Annual Report on Form 10-K. For further

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information on our critical and other significant accounting policies, see note 2 to our consolidated financial statements contained elsewhere in this Annual Report on Form 10-K.

### ***Revenue Recognition***

Our managed service contracts generally have an initial term of four to five years and various start and end dates. After the initial terms, these contracts renew annually unless canceled by either party. Revenue from managed service contracts consists of base fees and incentive payments.

We record revenue in accordance with the provisions of Staff Accounting Bulletin 104. As a result, we only record revenue once there is persuasive evidence of an arrangement, services have been rendered, the amount of revenue has become fixed or determinable and collectibility is reasonably assured. We recognize base fee revenues on a straight-line basis over the life of the managed service contract. Base fees for contracts which are received in advance of services delivered are classified as deferred revenue in the consolidated balance sheets until services have been provided.

Some of our service contracts entitle customers to receive a share of the cost savings achieved from operating their revenue cycle. This share is credited to the customers as a reduction in subsequent base fees. Services revenue is reported net of cost sharing and is referred to as net services revenue.

Our managed service contracts generally allow for adjustments to the base fee. Adjustments typically occur at 90, 180 or 360 days after the contract commences, but can also occur at subsequent dates as a result of factors including changes to the scope of operations and internal and external audits. All adjustments, the timing of which is often dependent on factors outside our control and which can increase or decrease revenue and operating margin, are recorded in the period the changes are known and collectibility of any additional fees is reasonably assured. Any such adjustments may cause our quarter-to-quarter results of operations to fluctuate. Adjustments may vary in direction, frequency and magnitude and generally have not materially affected our annual revenue trends, margin trends, and visibility.

We record revenue for incentive payments once the calculation of the incentive payment earned is finalized and collectibility is reasonably assured. We use a proprietary technology and methodology to calculate the amount of benefit each customer receives as a result of our services. Our calculations are based in part on the amount of revenue each customer is entitled to receive from commercial and private insurance carriers, Medicare, Medicaid and patients. Because the laws, regulations, instructions, payor contracts and rule interpretations governing how our customers receive payments from these parties are complex and change frequently, estimates of a customer's prior period benefits could change. All changes in estimates are recorded when new information is available and calculations are completed.

Incentive payments are based on the benefits a customer has received throughout the life of the managed service contract with us. Each quarter, we record the increase in the total benefits received to date. If a quarterly calculation indicates that the cumulative benefits to date have decreased, we record a reduction in revenue. If the decrease in revenue exceeds the amount previously paid by the customer, the excess is recorded as deferred revenue.

Our services also include collection of dormant patient accounts receivable that have aged 365 days or more directly from individual patients. We share all cash generated from these collections with our customers in accordance with specified arrangements. We record as revenue our portion of the cash received from these collections when each customer's cash application is complete.

### ***Accounts Receivable and Allowance for Uncollectible Accounts***

Base fees and incentive payments are billed to customers quarterly. Base fees received prior to when services are delivered are classified as deferred revenue.

We assess our customers' creditworthiness as a part of our customer acceptance process. We maintain an estimated allowance for doubtful accounts to reduce our gross accounts receivable to the amount that we

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believe will be collected. This allowance is based on our historical experience, our continuing assessment of each customer's ability to pay and the status of any ongoing operations with each applicable customer.

We perform quarterly reviews and analyses of each customer's outstanding balance and assess, on an account-by-account basis, whether the allowance for doubtful accounts needs to be adjusted based on currently available evidence such as historical collection experience, current economic trends and changes in customer payment terms. In accordance with our policy, if collection efforts have been pursued and all avenues for collections exhausted, accounts receivable would be written off as uncollectible.

### *Fair Value of Financial Instruments*

We record our financial assets and liabilities at fair value. The accounting standard for fair value (i) defines fair value as the price that would be received to sell an asset or paid to transfer a liability (an exit price) in an orderly transaction between market participants at the measurement date, (ii) establishes a framework for measuring fair value, (iii) establishes a hierarchy of fair value measurements based upon the observability of inputs used to value assets and liabilities, (iv) requires consideration of nonperformance risk, and (v) expands disclosures about the methods used to measure fair value.

The accounting standard establishes a three-level hierarchy of measurements based upon the reliability of observable and unobservable inputs used to arrive at fair value. Observable inputs are independent market data, while unobservable inputs reflect our assumptions about valuation. The three levels of the hierarchy are defined as follows:

- *Level 1:* Observable inputs such as quoted prices in active markets for identical assets and liabilities;
- *Level 2:* Inputs other than quoted prices but are observable for the asset or liability, either directly or indirectly. These include quoted prices for similar assets or liabilities in active markets and quoted prices for identical or similar assets or liabilities in markets that are not active; and model-derived valuations in which all significant inputs and significant value drivers are observable in active markets; and
- *Level 3:* Valuations derived from valuation techniques in which one or more significant inputs or significant value drivers are unobservable.

Our financial assets which are required to be measured at fair value on a recurring basis consist of cash and cash equivalents, which are invested in highly liquid money market funds and treasury securities and accordingly classified as level 1 assets in the fair value hierarchy. We do not have any financial liabilities which are required to be measured at fair value on a recurring basis.

### *Software Development*

We apply the provisions of Accounting Standards Codification, or ASC, 350-40, *Intangibles — Goodwill and Other — Internal-Use Software*, which requires the capitalization of costs incurred in connection with developing or obtaining internal use software. In accordance with ASC 350-40, we capitalize the costs of internally-developed, internal use software when an application is in the development stage. This generally occurs after the overall design and functionality of the application has been approved and our management has committed to the application's development. Capitalized software development costs consist of payroll and payroll-related costs for employee time spent developing a specific internal use software application or related enhancements, and external costs incurred that are related directly to the development of a specific software application.

### *Goodwill*

Goodwill represents the excess purchase price over the net assets acquired for a business that we acquired in May 2006. In accordance with ASC 350, *Intangibles — Goodwill and Other*, goodwill is not subject to amortization but is subject to impairment testing at least annually. Our annual impairment assessment date is the first day of our fourth quarter. We conduct our impairment testing on a company-wide basis because we



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have only one operating and reporting segment. Our impairment tests are based on our current business strategy in light of present industry and economic conditions and future expectations. As we apply our judgment to estimate future cash flows and an appropriate discount rate, the analysis reflects assumptions and uncertainties. Our estimates of future cash flows could differ from actual results. Our most recent impairment assessment did not result in goodwill impairment.

### *Impairments of Long-Lived Assets*

We evaluate all of our long-lived assets, such as furniture, equipment, software and other intangibles, for impairment in accordance with ASC 360, *Property, Plant and Equipment*, when events or changes in circumstances warrant such a review. If an evaluation is required, the estimated future undiscounted cash flows associated with the asset are compared to the asset's carrying amount to determine if an adjustment to fair value is required.

### *Income Taxes*

We record deferred tax assets and liabilities for future income tax consequences that are attributable to differences between the carrying amount of assets and liabilities for financial statement purposes and the income tax bases of such assets and liabilities. We base the measurement of deferred tax assets and liabilities on enacted tax rates that we expect will apply to taxable income in the year we expect to settle or recover those temporary differences. We recognize the effect on deferred income tax assets and liabilities of any change in income tax rates in the period that includes the enactment date. We provide a valuation allowance for deferred tax assets if, based upon the available evidence, it is more likely than not that some or all of the deferred tax assets will not be realized.

As of December 31, 2008 and in all prior periods, a valuation allowance was provided for all of our net deferred tax assets. As a result of our improved operations, in 2009 we determined that it was no longer necessary to maintain a valuation allowance for all of our deferred tax assets.

At December 31, 2009 and 2010, the primary sources of our deferred taxes were:

- differences in timing of depreciation on fixed assets;
- the timing of revenue recognition arising from incentive payments;
- employee compensation expense arising from stock options; and
- costs associated with the issuance of warrants to purchase shares of our common stock.

Beginning January 1, 2008, with the adoption of ASC 740-10, *Income Taxes — Overall*, we recognize the financial statement effects of a tax position only when it is more likely than not that the position will be sustained upon examination. Tax positions taken or expected to be taken that are not recognized under the pronouncement are recorded as liabilities. Interest and penalties relating to income taxes are recognized in our income tax provision in the statements of consolidated operations.

### *Share-Based Compensation Expense*

Our share-based compensation expense results from issuances of shares of restricted common stock and grants of stock options and warrants to employees, directors, outside consultants, customers, vendors and others. We recognize the costs associated with option and warrant grants using the fair value recognition provisions of ASC 718, *Compensation — Stock Compensation*. Generally, ASC 718 requires the value of share-based payments to be recognized in the statement of operations based on their estimated fair value at date of grant amortized over the grant's vesting period.

**Restricted Stock Plan.** Our restricted stock plan was adopted by our board of directors in March 2004, amended in June 2004, August 2004 and February 2005. As of February 28, 2011, all shares of common stock

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outstanding under our restricted stock plan were vested. We made the following grants to employees, directors and consultants under the restricted stock plan:

- In June 2004, we issued shares of common stock to certain employees and directors. In January 2005, we issued additional shares of common stock to a member of our board of directors. These shares vested on various schedules ranging from immediate vesting to vesting over a period of 48 months. As a result, we recorded share-based compensation expense of \$2,328 in 2008. We did not record any share-based compensation expense in 2009 or 2010 relating to these issuances.

***Ascension Health Stock and Warrants.*** In October 2004, Ascension Health became our founding customer. Since then, in exchange for its initial start-up assistance and subsequent sales and marketing assistance, we have issued common stock and granted warrants to Ascension Health, as described below:

- ***Initial Stock Issuance and Protection Warrant Agreement.*** In October and November 2004, we issued 3,537,306 shares of common stock to Ascension Health, then representing a 5% ownership interest in our company on a fully-diluted basis, and entered into a protection warrant agreement under which Ascension Health was granted the right to purchase additional shares of common stock from time to time for \$0.003 per share when Ascension Health's ownership interest in our company declined below 5% due to our issuance of additional stock or rights to purchase stock. The protection warrant agreement expired on the closing of our initial public offering in May 2010. We made the initial stock grant and entered into the protection warrant agreement because Ascension Health agreed to provide us with an operational laboratory and related start-up consulting services in connection with our development of our initial revenue cycle management service offering.

In 2008 and 2009, we granted Ascension Health the right to purchase 91,183 and 136,372 shares of common stock for \$0.003 per share, respectively, pursuant to the protection warrant agreement. We accounted for the costs associated with these purchase rights as a reduction in base fee revenues due to us from Ascension Health because we could not reasonably estimate the fair value of the services provided by Ascension Health. Accordingly, we reduced the amount of our base fee revenues from Ascension Health by \$0.9 million and \$1.7 million in 2008 and 2009, respectively. There were no grants associated with this agreement during 2010 and no costs were recorded. As of December 31, 2010, there were no protection warrants outstanding and no additional warrant rights may be earned under this agreement. For additional information regarding our relationship with Ascension Health, see "Related Person Transactions — Transactions With Ascension Health".

- ***Supplemental Warrant.*** Pursuant to a supplemental warrant agreement that became effective in November 2004, Ascension Health had the right to purchase up to 3,537,306 shares of our common stock based upon the achievement of specified milestones relating to its sales and marketing assistance. The supplemental warrant agreement expired on the closing of our initial public offering in May 2010.

During March 2008, Ascension Health earned the right to purchase 437,268 shares of common stock for \$10.25 per share, and we recorded \$2.4 million in marketing expense.

During March 2009, Ascension Health earned the right to purchase 437,264 shares of common stock for \$13.02 per share, and we recorded \$2.8 million in marketing expense. No warrants were earned during year ended December 31, 2010. Ascension Health was issued 615,649 shares of common stock as a result of cashless exercise of outstanding supplemental warrants during the year ended December 31, 2010. The supplemental warrant with respect to 437,264 shares of common stock expired in connection with our initial public offering.

As of December 31, 2010, there were no supplemental warrants outstanding; no additional warrant rights may be earned under the Supplemental Warrant Agreement.

***Licensing and Consulting Warrant.*** In conjunction with the start of our business, in February 2004, we executed a term sheet with a consulting firm and its principal, Zimmerman LLC (formerly known as Zimmerman and Associates) and Michael Zimmerman, respectively, contemplating that we would grant to Mr. Zimmerman a warrant, with an exercise price equal to the fair market value of our common stock upon

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grant, to purchase shares of our common stock then representing 2.5% of our equity in exchange for exclusive rights to certain revenue cycle methodologies, tools, technology, benchmarking information and other intellectual property, plus up to another 2.5% of our equity at the time of grant if the firm's introduction of us to senior executives at prospective customers resulted in the execution of managed service contracts between us and such customers. In January 2005, we formalized the license and warrant grant contemplated by the term sheet and granted to Mr. Zimmerman a warrant to purchase 3,266,668 shares of our common stock for \$0.29 per share, representing 5% of our equity at that time. In 2005, we recorded \$0.5 million in selling, general and administrative expense in conjunction with this warrant grant. Mr. Zimmerman subsequently assigned certain of the warrant rights to trusts, the beneficiaries of which are members of Mr. Zimmerman's immediate family. In December 2010, Mr. Zimmerman and the trusts exercised the warrant rights in full to purchase 3,266,668 shares of our common stock for \$0.29 per share. As of December 31, 2010, the warrant was no longer outstanding and no additional warrant rights may be earned under this agreement.

We used the Black-Scholes option pricing model to determine the estimated fair value of the above purchase rights at the date earned. The following table sets forth the significant assumptions used in the model during 2008 and 2009:

|                         | Year Ended December 31, |           |
|-------------------------|-------------------------|-----------|
|                         | 2008                    | 2009      |
| Future dividends        | —                       | —         |
| Risk-free interest rate | 3.45%                   | 2.91%     |
| Expected volatility     | 50%                     | 50%       |
| Expected life(1)        | 6.6 years               | 5.6 years |

(1) Expected life applies to Ascension Health's supplemental warrant only, since the other warrants were fully vested upon grant.

**Stock Option Plans.** In December 2005, our board of directors approved a stock option plan, which provided for the grant of stock options to employees, directors and consultants. The plan was amended and restated in February 2006 and further amended in May 2007, October 2008, January 2009 and November 2009. In April 2010, we adopted a new 2010 stock incentive plan, or the 2010 plan, which became effective immediately prior to the closing of our initial public offering and, accordingly, no further stock option grants will be made under the 2006 plan. The 2010 plan provides for the grant of incentive stock options, non-statutory stock options, restricted stock awards and other stock-based awards.

As of December 31, 2010, an aggregate of 15,749,404 shares were subject to outstanding options under both plans, and 8,054,762 shares were available for grant. To the extent that previously granted awards under the 2006 plan or 2010 plan expire, terminate or are otherwise surrendered, cancelled, forfeited, or repurchased by us, the number of shares available for future awards under the 2010 plan will increase, up to a maximum of 24,374,756 shares. Under the terms of both plans, all options will expire if they are not exercised within ten years after the grant date. Substantially all of the options vest over four years at a rate of 25% per year on each grant anniversary date. Options granted under the 2006 plan can be exercised immediately upon grant, but upon exercise the shares issued are subject to the same vesting and repurchase provisions that applied before the exercise. Options granted under the 2010 plan cannot be exercised prior to vesting.

We use the Black-Scholes option pricing model to determine the estimated fair value of each option as of its grant date. These inputs are subjective and generally require significant analysis and judgment to develop.

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The following table sets forth the significant assumptions used in the Black-Scholes model to calculate stock-based compensation expense for grants made during 2008, 2009 and 2010.

|                         | Year Ended December 31, |                |                |
|-------------------------|-------------------------|----------------|----------------|
|                         | 2008                    | 2009           | 2010           |
| Future dividends        | —                       | —              | —              |
| Risk-free interest rate | 2.8 to 4.0%             | 1.6% to 3.2%   | 1.6% to 2.6%   |
| Expected volatility     | 50%                     | 50%            | 50%            |
| Expected life           | 6.25 years              | 6.25 years     | 6.25 years     |
| Forfeitures             | 3.75% annually          | 4.25% annually | 4.25% annually |

As a newly public company, it is not practical for us to estimate the expected volatility of our share prices based on our limited public trading history. Therefore, we estimated the expected volatility by reviewing the historical volatility of the common stock of public companies that operate in similar industries or were similar in terms of stage of development or size and then projecting this information toward our future expected results. We used judgment in selecting these companies, as well as in evaluating the available historical and implied volatility for these companies.

We aggregated all employees into one pool for valuation purposes. The risk-free rate is based on the U.S. treasury yield curve in effect at the time of grant.

The plan was not in existence a sufficient period for us to have used our historical experience to estimate expected life. Furthermore, data from other companies was not readily available. Therefore, we estimated our stock options' expected life using a simplified method based on the average of each option's vesting term and original contractual term.

An estimated forfeiture rate derived from our historical data and our estimates of the likely future actions of option holders was applied when recognizing the share-based compensation expense of the options.

We continue to use judgment in evaluating the expected term, volatility and forfeiture rate related to our share-based compensation on a prospective basis, and in incorporating these factors into the Black-Scholes pricing model. Higher volatility and longer expected lives result in an increase to total share-based compensation expense determined at the date of grant. In addition, any changes in the estimated forfeiture rate can have a significant effect on reported share-based compensation expense, as the cumulative effect of adjusting the rate for all expense amortization is recognized in the period that the forfeiture estimate is changed. If a revised forfeiture rate is higher than the previously estimated forfeiture rate, an adjustment is made that will result in a decrease to the share-based compensation expense recognized in our consolidated financial statements. If a revised forfeiture rate is lower than the previously estimated forfeiture rate, an adjustment is made that will result in an increase to the share based compensation expense recognized in our consolidated financial statements. These adjustments will affect our infused management and technology expenses and selling, general and administrative expenses.

For service-based equity awards, which represent all outstanding option grants as of December 31, 2010, compensation expense is recognized, net of forfeitures, using a straight-line method over the applicable vesting period. Quarterly, the stock based compensation expense is adjusted to reflect 100% of expense for options that vested during the period. The allocation of this cost between cost of services, selling, general and administrative expenses and infused management and technology expenses will depend on the salaries and work assignments of the personnel holding these stock options.

Prior to our initial public offering, stock options represented the right to purchase shares of our non-voting common stock. All outstanding non-voting common stock converted into voting common stock on a share-for-share basis effective May 19, 2010, and accordingly, stock options to purchase non-voting common stock represent stock options to purchase voting common stock, with no other changes in their terms.

As of December 31, 2010, we had \$52.0 million of total unrecognized share-based compensation expense related to employee stock options. We expect to recognize this cost over a weighted-average period of 2.8 years after January 1, 2011. The allocation of this cost between cost of services, selling, general and administrative

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expenses and infused management and technology expenses will depend on the salaries and work assignments of the personnel holding these stock options.

*Determination of Fair Value.* Valuing the share price of a privately-held company is complex. We believe that prior to our initial public offering we used reasonable methodologies, approaches and assumptions in assessing and determining the fair value of our common stock for financial reporting purposes. Prior to our initial public offering, we determined the fair value of our common stock through periodic internal valuations that were approved by our board of directors. The fair value approved by our board was used for all option grants until such time as a new determination of fair value was made. To date, and as permitted by our stock option plan, our chief executive officer has selected option recipients and determined the number of shares covered by, and the timing of, option grants.

Our stock valuations used a combination of the market-comparable approach and the income approach to estimate an enterprise value of our company at each valuation date. Our board considered the following factors when determining the fair value of our common stock:

- our financial condition, sales levels and results of operations during the relevant period;
- developments in our business;
- hiring of key personnel;
- forecasts of our financial results and market conditions affecting our industry;
- market values, sales levels and results of operations for public companies that we consider comparable in terms of size, service offerings and maturity;
- the superior rights and preferences of outstanding securities that were senior to our common stock; and
- the illiquid nature of our common stock

There is inherent uncertainty in the forecasts and projections that were used in our common stock valuations prior to our initial public offering. If we had made different assumptions and estimates than those described above, the amount of our share-based compensation expense, net income or loss and related per-share amounts could have been materially different.

For grants following the initial public offering, we utilized market-based share prices of our common stock in the Black-Scholes option pricing model to calculate the fair value of our common stock option awards. The Black-Scholes model involves a number of highly subjective estimates such as the length of time employees will retain their vested stock options before exercising them (the “expected term”), the estimated forfeitures over the applicable vesting period, and the estimated volatility of our common common stock over the expected term.

## *Legal Proceedings*

In the normal course of business, we are involved in legal proceedings or regulatory investigations. We evaluate the need for loss accruals using the requirements of ASC 450, *Contingencies*. When conducting this evaluation we consider factors such as the probability of an unfavorable outcome and the ability to make a reasonable estimate of the amount of loss. We record an estimated loss for any claim, lawsuit, investigation or proceeding when it is probable that a liability has been incurred and the amount of the loss can reasonably be estimated. If the reasonable estimate of a probable loss is a range, and no amount within the range is a better estimate, then we record the minimum amount in the range as our loss accrual. If a loss is not probable or a probable loss cannot be reasonably estimated, no liability is recorded.

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### Results of Operations

The following table sets forth consolidated operating results and other operating data for the periods indicated.

|   | Year Ended December 31, |           |            |
|---|-------------------------|-----------|------------|
|   | 2008                    | 2009      | 2010       |
|   | (In thousands)          |           |            |
| <b>Statement of Operations Data:</b>  |                         |           |            |
| Net services revenue  | \$398,469               | \$510,192 | \$606,294  |
| Costs of services   | 335,211                 | 410,711   | 478,276    |
| Operating margin  | 63,258                  | 99,481    | 128,018    |
| Infused management and technology expense   | 39,234                  | 51,763    | 64,029     |
| Selling, general and administrative expense   | 21,227                  | 30,153    | 41,671     |
| Total operating expenses  | 60,461                  | 81,916    | 105,700    |
| Income from operations  | 2,797                   | 17,565    | 22,318     |
| Net interest income (expense)   | 710                     | (9)       | 29         |
| Income before provision for income taxes  | 3,507                   | 17,556    | 22,347     |
| Provision for income taxes  | 2,264                   | 2,966     | 9,729      |
| Net income  | \$ 1,243                | \$ 14,590 | \$ 12,618  |
| <b>Operating Expense Details:</b>   |                         |           |            |
| Infused management and technology expense, excluding depreciation and amortization expense and share-based compensation expense   | \$ 35,079               | \$ 45,365 | \$ 53,230  |
| Selling, general and administrative expense, excluding depreciation and amortization expense and share-based compensation expense | 16,879                  | 22,940    | 32,280     |
| Depreciation and amortization expense(1)  | 2,540                   | 3,921     | 4,866      |
| Share-based compensation expense(1)(2)  | 5,963                   | 9,690     | 15,324     |
| Total operating expenses  | \$ 60,461               | \$ 81,916 | \$ 105,700 |

- (1) In 2010, as our shared services centers model adoption by customers increased, we started allocating a portion of our share-based compensation expense and depreciation and amortization expense to cost of services. For the year ended December 31, 2010, \$1,291 of depreciation and amortization expense was allocated to cost of services.
- (2) Share-based compensation expense includes share-based compensation expense and warrant-related expense, exclusive of warrant expense of \$921 and \$1,736 which was classified as a reduction in base fee revenue for the years ended December 31, 2008 and 2009, respectively. No such reduction was recorded for the year ended December 31, 2010 as all warrants had been earned and therefore there was no stock warrant expense. For the year ended December 31, 2010, \$1,225 of share-based compensation expense was allocated to cost of services.

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***Year Ended December 31, 2009 Compared to Year Ended December 31, 2010***

***Net Services Revenue***

The following table summarizes the composition of our net services revenue for the years ended December 31, 2009 and 2010:

|  | <u>2009</u>           | <u>2010</u>      |
|--|-----------------------|------------------|
|  | <u>(In thousands)</u> |                  |
| Net base fees for managed service contracts      | \$434,281             | \$518,243        |
| Incentive payments for managed service contracts | 64,033                | 74,663           |
| Other services                                   | 11,878                | 13,388           |
| Total  | <u>\$510,192</u>      | <u>\$606,294</u> |

Net services revenue increased by \$96.1 million, or 18.8%, to \$606.3 million for the year ended December 31, 2010 from \$510.2 million for the year ended December 31, 2009. The largest component of the increase, net base fee revenue, increased by \$84.0 million, or 19.3%, to \$518.2 million for the year ended December 31, 2010 from \$434.3 million for the year ended December 31, 2009, primarily due to an increase in the number of hospitals with whom we had managed service contracts. The number of hospitals increased to 66 as of December 31, 2010 from 54 as of December 31, 2009. Of the \$84.0 million increase in net base fee revenues, \$65.2 million was attributable to new managed service contracts entered into during 2010. In addition, incentive payment revenues increased by \$10.6 million, or 16.6%, to \$74.7 million for the year ended December 31, 2010 from \$64.0 million for the year ended December 31, 2009, consistent with the increases that generally occur as our managed service contracts mature. All other revenues increased by \$1.5 million, or 12.7%, to \$13.4 million for the year ended December 31, 2010 from \$11.9 million for the year ended December 31, 2009, as we increased the number of customers using our dormant patient accounts receivable collection services and continued to expand our specialized services such as emergency room physician advisory services. We recognized no revenue from our quality and total cost of care offering in 2010. Our projected contracted annual revenue run rate at December 31, 2010 was \$698 million to \$713 million compared to \$509 million to \$519 million at December 31, 2009. Based on the midpoint of the two ranges, our projected contracted annual revenue run rate as of December 31, 2010 increased by \$192 million, or 37.3%.

***Costs of Services***

Our costs of services increased by \$67.6 million, or 16.5%, to \$478.3 million for the year ended December 31, 2010 from \$410.7 million for the year ended December 31, 2009. The increase in costs of services was primarily attributable to the increase in the number of hospitals for which we provide managed services.

***Operating Margin***

Operating margin increased by \$28.5 million, or 28.7%, to \$128.0 million for the year ended December 31, 2010 from \$99.5 million for the year ended December 31, 2009. The increase consisted primarily of:

- \$10.6 million in additional incentive payments under managed service contracts;
- an increase of \$16.5 million in the operating efficiencies associated with our revenue cycle operations including the impact of shared service center adoptions; and
- reduction of \$1.7 million in costs related to the issuance of warrants to Ascension Health as there were no warrants issued to Ascension Health in the year ended December 31, 2010.

The increase in operating margin in absolute dollars was accompanied by an increase in operating margin as a percentage of net services revenue to 21.1% for the year ended December 31, 2010 from 19.5% for the

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year ended December 31, 2009, primarily due to an increased ratio of mature managed service contracts to new managed service contracts.

### *Operating Expenses*

Infused management and technology expenses increased by \$12.3 million, or 23.7%, to \$64.0 million for the year ended December 31, 2010 from \$51.8 million for the year ended December 31, 2009. The increase in infused management and technology expenses was primarily due to the increase in the number of our management personnel deployed at customer facilities, reflecting an increase in the number of hospitals with whom we had managed service contracts, and an increase of \$1.0 million in costs to operate our inaugural quality and total cost of care contract, as well as the items noted below.

Selling, general and administrative expenses increased by \$11.5 million, or 38.2%, to \$41.7 million for the year ended December 31, 2010 from \$30.2 million for the year ended December 31, 2009. The increase included \$3.4 million to develop our new quality and total cost of care offering, \$2.8 million for increases in sales and marketing personnel costs, \$1.5 million for a provision for bad debt expense, and \$1.3 million in costs related to becoming a public company. The increase also included \$2.2 million of additional depreciation, amortization and share-based compensation expense as discussed below.

We allocate share-based compensation expense and depreciation and amortization expense between cost of services, infused management expenses and selling, general and administrative expenses. During the year ended December 31, 2010, the following changes affected the operating expenses categories:

- Depreciation and Amortization expense increased by \$0.9 million, or 24.1%, to \$4.9 million for the year ended December 31, 2010 from \$3.9 million for the year ended December 31, 2009, due to the addition of computer equipment, furniture and fixtures, and other property to support our growing operations. Amortization expense increased mainly due to amortization of internally developed software.
- Share-based compensation expense, which includes both stock-based compensation expense and stock warrant expense, increased \$5.6 million, or 58.1%, to \$15.3 million in the year ended December 31, 2010 from \$9.7 million for the year ended December 31, 2009. The increase was due to an additional \$8.4 million of option expense relating to stock option grants during the current year and vesting of previously granted stock options associated with the continued increase in the number of employees, offset by a decrease in stock warrant expense charge of \$2.8 million.

In 2010, approximately \$1.2 million and \$1.3 million of stock-based compensation expense and depreciation and amortization expense, respectively was allocated to cost of services due to the expansion of our shared services centers.

### *Income Taxes*

Tax expense increased by \$6.8 million, to \$9.7 million for the year ended December 31, 2010 from \$3.0 million for the year ended December 31, 2009. The increase in 2010 tax expense was primarily due to the increase in taxable income during the period and release of deferred tax asset valuation allowance of \$3.5 million in 2009. Our tax provision for the year ended December 31, 2010 was equal to approximately 44% of our pre-tax income and differed from the federal statutory rate of 35% mainly due to the impact of certain state taxes which are based on gross receipts, as compared to 17% for the year ended December 31, 2009. The 17% tax rate in 2009 was mainly due to the release of the tax valuation allowance in 2009.

### *Net Income*

Net income decreased \$2.0 million, to \$12.6 million for the year ended December 31, 2010 from net income of \$14.6 million for the year ended December 31, 2009. Although our income from operations increased by \$4.8 million during the year ended December 31, 2010, it was offset by the increase in our income tax expense of \$6.8 million. The increase in 2010 income tax expense was primarily the result of the



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increase in taxable income during 2010 and release of deferred tax valuation allowance of \$3.5 million in 2009, which reduced our overall tax liability in that year.

***Year Ended December 31, 2008 Compared to Year Ended December 31, 2009******Net Services Revenue***

The following table summarizes the composition of our net services revenue for the years ended December 31, 2008 and 2009:

|  | 2008             | 2009             |
|--|------------------|------------------|
|  | (In thousands)   |                  |
| Net base fees for managed service contracts      | \$350,085        | \$434,281        |
| Incentive payments for managed service contracts | 38,971           | 64,033           |
| Other services                                   | 9,413            | 11,878           |
| Total  | <u>\$398,469</u> | <u>\$510,192</u> |

Net services revenue increased \$111.7 million, or 28.0%, to \$510.2 million for the year ended December 31, 2009 from \$398.5 million for the year ended December 31, 2008. The largest component of the increase, net base fee revenue, increased \$84.2 million, or 24.1%, to \$434.3 million for the year ended December 31, 2009 from \$350.1 million for the year ended December 31, 2008, primarily due to an increase in the number of hospitals with whom we had managed service contracts from 46 as of December 31, 2008 to 54 as of December 31, 2009. Of the \$84.2 million increase in net base fee revenues, \$61.1 million was attributable to new managed service contracts entered into during 2009. In addition, incentive payment revenues increased by \$25.1 million, or 64.3%, to \$64.0 million for the year ended December 31, 2009 from \$39.0 million for the year ended December 31, 2008, consistent with the increases that generally occur as our managed service contracts mature. All other revenues increased by \$2.5 million, or 26.2%, to \$11.9 million for the year ended December 31, 2009 from \$9.4 million for the year ended December 31, 2008, as we increased the number of customers using our dormant patient accounts receivable collection services and continued to expand our specialized services such as emergency room physician advisory services. Net patient revenue under our management increased by \$2.7 billion, or 29.7%, to \$12.0 billion for the year ended December 31, 2009 from \$9.2 billion for the year ended December 31, 2008. Our projected contracted annual revenue run rate at December 31, 2009 was \$509 million to \$519 million compared to \$421 million to \$430 million at December 31, 2008. Based on the midpoint of the two ranges, our projected contracted annual revenue run rate as of December 31, 2009 increased by \$89 million, or 20.8%.

***Costs of Services***

Our costs of services increased \$75.5 million, or 22.5%, to \$410.7 million for the year ended December 31, 2009 from \$335.2 million for the year ended December 31, 2008. The increase in costs of services was primarily attributable to the increase in the number of hospitals for which we provide managed services.

***Operating Margin***

Operating margin increased \$36.2 million, or 57.3%, to \$99.5 million for the year ended December 31, 2009 from \$63.3 million for the year ended December 31, 2008. The increase consisted primarily of:

- \$25.1 million in additional incentive payments under managed service contracts;
- an increase of \$0.6 million in the operating margin associated with our other services, as a result of the continued expansion of our dormant patient accounts receivable collection and other ancillary services; and
- a reduction of \$11.3 million in revenue cycle operating costs under managed service contracts, net of customer cost sharing.

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The above was partially offset by an increase of \$0.8 million in costs related to the issuance of warrants to Ascension Health during the year ended December 31, 2009.

The increase in operating margin in absolute dollars was accompanied by an increase in operating margin as a percentage of net services revenue from 15.9% for the year ended December 31, 2008 to 19.5% for the year ended December 31, 2009, primarily due to an increased ratio of mature managed service contracts to new managed service contracts.

### *Operating Expenses*

Infused management and technology expenses increased \$12.6 million, or 31.9%, to \$51.8 million for the year ended December 31, 2009 from \$39.2 million for the year ended December 31, 2008. The increase in infused management and technology expenses was primarily due to the increase in the number of our management personnel deployed at customer facilities, reflecting an increase in the number of hospitals with whom we had managed service contracts, as well as the items noted below.

Selling, general and administrative expenses increased \$8.9 million, or 42.1%, to \$30.2 million for the year ended December 31, 2009 from \$21.2 million for the year ended December 31, 2008. The increase included \$1.4 million of costs, or 15.3% of the increase, for enhancing and maintaining our accounting systems, documenting internal controls, establishing an internal audit function and other costs associated with our preparation to be a public company. The increase also included additional research and development costs of \$1.0 million, or 11.4% of the increase, to develop our new quality/cost service initiative. The increase also included \$2.8 million, or 31.8% of the increase, related to additional depreciation, amortization and share-based compensation expenses, as discussed below. The remaining increase of \$3.7 million, or 41.5% of the increase, was primarily due to increases in our personnel costs to support our expanding customer base.

We allocate our other operating expenses between the infused management expenses and selling, general and administrative expenses. During the year ended December 31, 2009, the following changes affected both categories:

- Share-based compensation expense increased \$3.4 million, or 94.8%, to \$6.9 million for the year ended December 31, 2009 from \$3.6 million for the year ended December 31, 2008 due to employee option grants and vesting of previously granted stock options associated with the continued expansion of our personnel and the increase in the fair market value of our stock, which increases the cost of option grants calculated using the provisions of ASC 718.
- Depreciation expense increased \$0.7 million, or 50.6%, to \$2.0 million for the year ended December 31, 2009 from \$1.3 million for the year ended December 31, 2008, due to the addition of computer equipment, furniture and fixtures, and other property to support our growing operations.
- Amortization expense increased \$0.7 million, or 58.5%, to \$1.9 million for the year ended December 31, 2009 from \$1.2 million for the year ended December 31, 2008. The majority of this increase resulted from amortization of internally developed software.

### *Income Taxes*

Tax expense increased \$0.7 million, or 31.0%, to \$3.0 million for the year ended December 31, 2009 from \$2.3 million for the year ended December 31, 2008. The increase in 2009 tax expense was primarily due to the increase in taxable income during the period, offset by the release of deferred tax asset valuation allowance of \$3.5 million. Our tax provision for the year ended December 31, 2009 was equal to approximately 17% of our pre-tax income as compared to 65% for the year ended December 31, 2008. The decrease was mainly due to the release of the tax valuation allowance.